Brexit: implications for airlines

Planning for an uncertain outcome

November 2016

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British aviation in Europe at a glance

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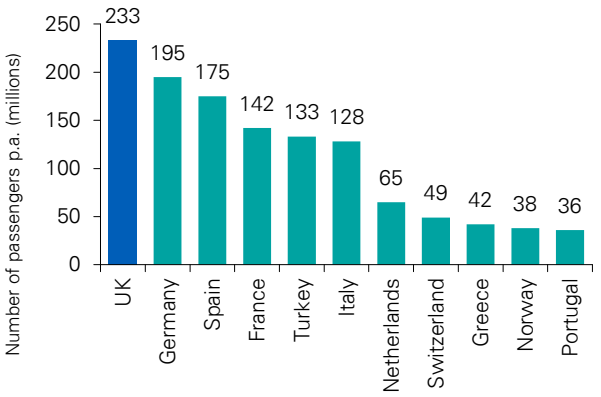
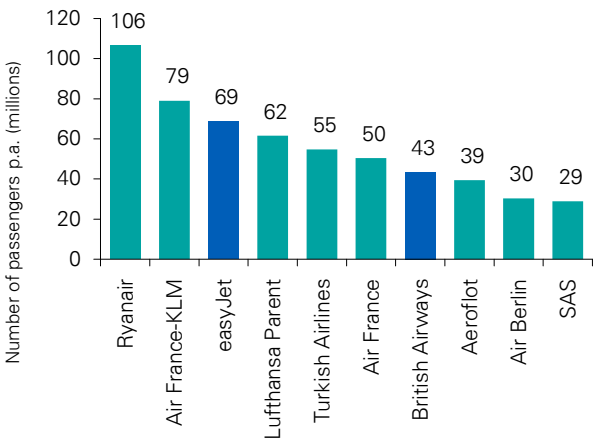


Note: Represents ECAA countries plus candidate countries
Source: eurostat

Figure 2: Top 10 European Airlines by Passengers



Source: Airline Analyst

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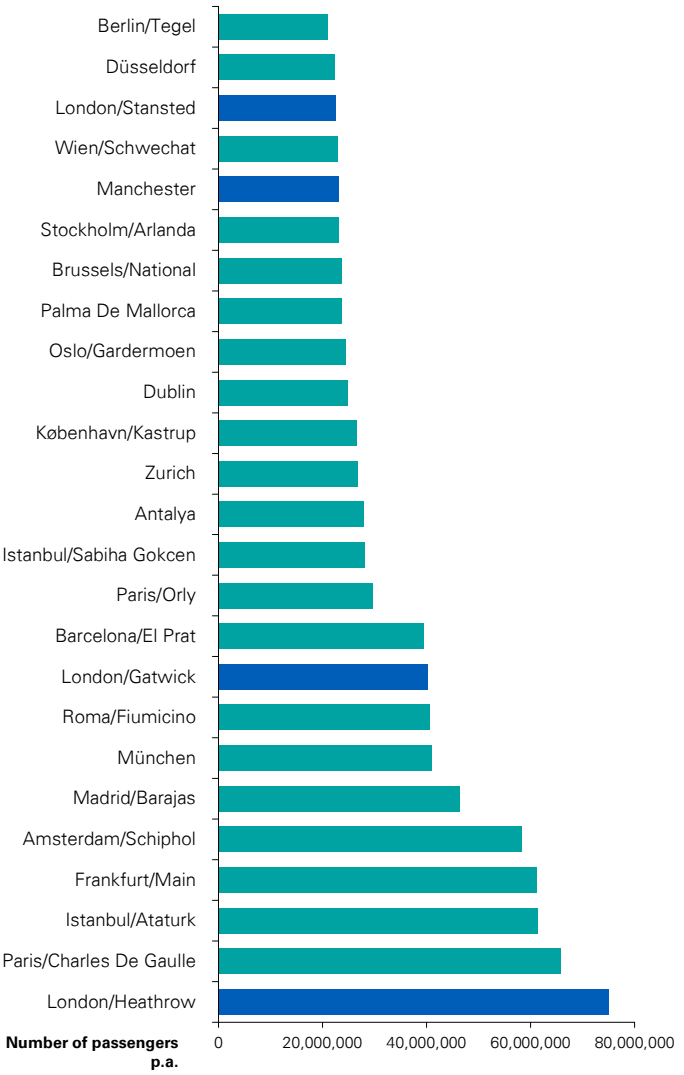

Source: Eurostat

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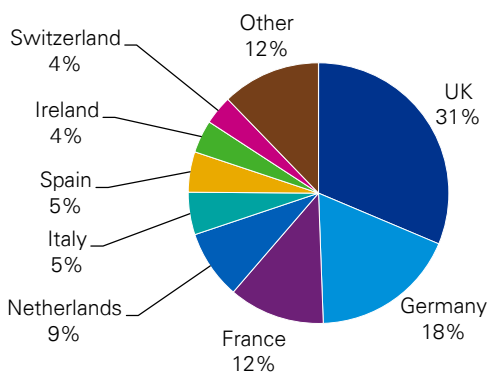

Source: US Department for Transportation, filing for year-end June 2015

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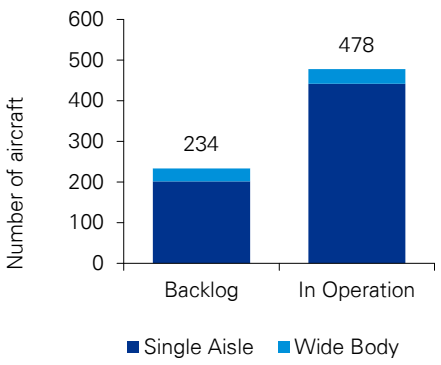

Note: (Single Aisle: A318-A321 families; Wide-Body: A330, A340, A350, A380. Based on UK registered airlines only, but excludes airlines owned by international groups and joint ventures, but with control from the UK
Source: KPMG analysis, Airbus

Foreword

There is significant uncertainty around the way in which Brexit will affect the airline industry. However, we believe there are many reasons why a drastic change to the UK aviation market would neither be in Europe nor global stakeholders' best interests. This is not to say that individual airlines and countries will not seek to maximize their own benefits in any negotiation: they clearly will. But the bigger picture is that the global airline market has an interest in making the post-Brexit transition as seamless as possible.

It is important to remember that the liberalisation of the European aviation market in the early 1990s revolutionised air travel across the continent. Since then, the number of journeys within the EU has soared: scheduled passengers carried between the UK and EU increased from 69 million passengers in 1996 to over 130 million in 2015. More strikingly, the passengers carried by UK based airlines to Europe increased eight-fold between 1993 and 2014: from 9.9 to 78.0 million(1), and analysis by the transport team at KPMG indicates that the top eight UK based airlines generated over £10.5 billion of revenues from travel between the UK and EU(2). Agreements between the EU and major markets like the US(3) have further driven choice outside EU borders.

As we set out in the first chapter of this document, the Brexit announcement hit global airline share prices significantly. Internationally, this is likely to be driven by general economic uncertainty. But airlines took a disproportionally high value reduction compared to other industries. We think that this is because the markets recognise that the UK is a very significant part of a highly interconnected global airline ecosystem:

— The UK is the EU's biggest airline market as measured by passenger numbers (Figure 1);

— 138 million passengers travelled between UK airports and the EU in 2015(4), often representing a very significant percentage of that country's total traffic(5);

— Two UK headquartered airlines are in the top-10 European airlines (as measured by passenger number). In addition, in IAG and Virgin, the UK hosts airlines forming two of the biggest transatlantic joint ventures, with US partners American Airlines, and Delta respectively (Figure 2);

— The UK has four of the top 25 busiest EU airports by passenger numbers (Figure 3);

— According to analysis by Airbus and Sabre, the UK hosts two of Europe's 11 'Aviation Mega Cities'(6) (London and Manchester), of which there are 55 worldwide.

— In global terms, the Europe-North America passenger market represents the 4th biggest passenger flow in the world in 2015 , behind only domestic traffic flows in North America, Europe, and China respectively. The UK is – by some margin – the biggest gateway to the US from Europe, representing 31% of total traffic (Figure 4);

— UK based airlines have very significant orders placed with the two major original equipment manufacturers (OEMs): Boeing and Airbus. As Airbus is a major European (and UK) employer, this could form a significant component of any negotiation between the EU and UK (Figure 5).

Given the above, how should airlines begin to plan for Brexit?

Some senior industry participants have described a sense of Brexit paralysis i.e. it is too hard to plan until there is more certainty, and there won't be certainty until there is a plan.

For investors this won't be an acceptable response: they will want certainty of outcome before any political settlement is reached. We believe that by breaking down "Brexit" into a series of addressable questions, it is possible to create a contingency plan that at least allows the business to understand the cost of appearing to operate on a business-as-usual basis.

While visibility is (and will remain) limited in some key areas, there are options and contingency plans, risks, and opportunities that can help shape each airline's response even if that considered response is, in some circumstances, "wait".

We also believe that a purely legal approach to the Brexit question is unlikely to be successful. Reliance on knowledge about how treaties work, what legislation may revert to, and how contracts are framed by EU law are very important, but the response to Brexit requires a whole-business response: an ability to be agile in order to change course in-flight if as the environment becomes clearer.

James Stamp

Global Head of Aviation and UK Head of Transport

Notes: (1) EEA scheduled passengers, based on CAA statistics
(2) UK-EU traffic approximated by UK-Europe traffic.
(3) EU-US Open Skies allows any airline of the EU and any airline of the United States to fly between their respective territories, and became effective in 2008
(4) Source: Boeing Current Market Outlook 2016 to 2035. Passenger flows measured by Revenue Passenger Km (RPK's)
(5) Source: US Department of Transportation statistics, June 2015.
(6) Cities with more than 10,000 daily long-haul passengers (sectors > 2,000nm excluding domestic)

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Understanding the financial impact

While other industries might be feeling pain in their operations and supply-chain, sectors that rely on a freedom that may soon be taken away were clearly hit harder

The initial reaction of the capital markets to Brexit on the airline sector globally was an average reduction in share prices of 25%[7], with listed UK airlines down by an average of 33%. However, it has posed a key question: did the long term value of global airlines really diminish by 25% overnight when the UK voted to leave the EU? It is likely that at least some portion of this reduction in value was due to global jitters, and general uncertainty rather than a change in long term fundamentals.

Figure 6: Reduction in airline and tour operator share-prices post Brexit

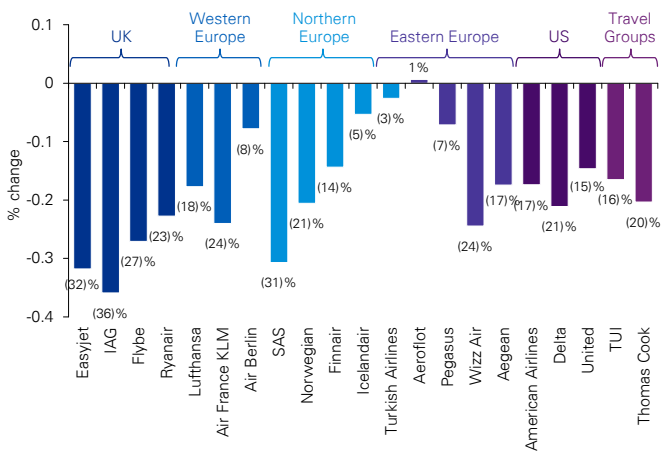
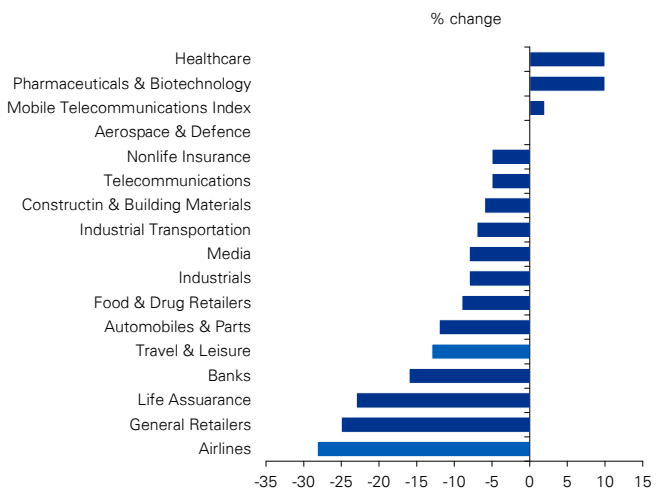


Figure 7: Impact of Brexit on industry sub-segments[8]



However, as the chart above shows, there is no doubt that airlines have been significantly impacted, with only banks, insurance, and general retail coming under similar pressure.

Why did airline shares get hit so hard?

Firstly, it is worth noting that there are significant parallels between the (badly hit) financial services sector and airlines: both are regulated at European level and require EU level permissions to sell to their customers; and each relies on one of the EU's four fundamental freedoms of movement (capital in the case of financial services, and people/cargo for airlines) to do what they do. So while other industries might feel pain in their operations and supply-chain, sectors that rely on a freedom that might be taken away were clearly impacted harder.

Secondly, even prior to Brexit, airlines in Europe were under pressure:

— In short-haul, the European market has been categorised by excess short-haul capacity, as a result of the presence of aggressive low cost carriers forcing "legacy" network carriers to cut-costs to compete; and

— In long-haul, competition from the Middle Eastern carriers, with huge investments in new long-haul fleet, "gateway" hub-airports, and an arms race for the best hard and soft product.

The correlation between capacity (which is hard to adjust in the short term) and profitability in aviation is well understood (see Figure 8). Capacity rationalisation has not happened to any significant extent so far, mainly because of low fuel prices and cheap financing, combined with the OEM's desire to sell more of their next-generation aircraft, leading to record order books.

Thirdly, the European airline market (particularly in the leisure space) has been impacted by the security situation in Europe and North Africa, and geo-political events such as seen in Turkey. This results in further demand being re-routed to "safe" destinations, putting pressure on yields (not to mention hotel inventory).

Finally, as we discuss further below, the impact on the pound has caused overseas holidays for UK consumers to be more expensive: the vacation becomes the staycation.

Impact on dividend policy and dividend yield

Listed airlines will need to assess the impact on dividend policy. This will impact UK airlines (of which there are relatively few public stand-alone entities); airline groups with significant UK subsidiaries; and EU and global airlines with UK exposure. Those airlines generating income from outside the UK will be (at least in part) shielded from the impact of the depreciation of sterling more than those with more GBP exposure.

Notes: (7) Amongst the airlines sampled below, and based on change in share price between 28 May and 28 June 2016. (Source: Google and Yahoo Finance)
(8) Share price movements between 21st and 27th June. Source: CapitalIQ, and KPMG analysis

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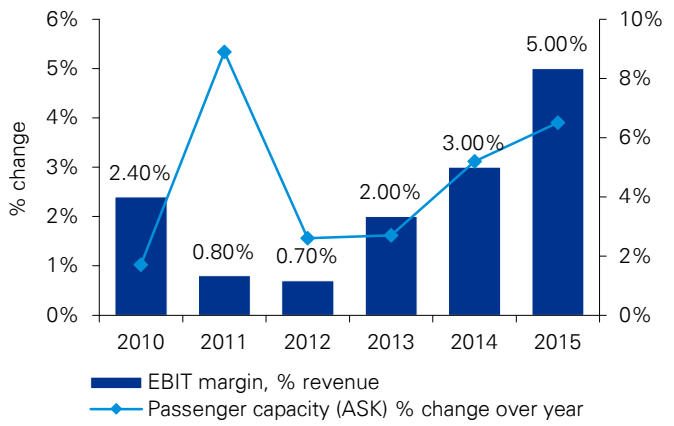
Figure 8: Correlation between capacity and profitability in the airline market



Source: IATA, and KPMG analysis.

What questions should airlines be asking?

While Brexit was a shock, it is clear that not all airlines will – or should be - impacted equally. Airlines (and their investor relations teams) should be asking themselves:

1. How is my business model affected relative to my competition, and what might their response be? This should consider:
   a) Who are my customers and why do they travel (a UK outbound leisure customer base will react differently to an airline with a significant migrant worker component)?
   b) What proportion of my traffic is intra-EU (vs. UK-EU)?
2. How do I update my equity story to the market and analysts?
3. What is the impact on my dividend policy compared to fleet investment?
4. How robust are my competitors, and what opportunities might this open up for me?
5. When should I be looking to raise funds?

Negotiating a new relationship

The ability of airlines to continue accessing the markets into which they transport passengers and cargo is the most important Brexit issue for any carrier whose operations touch the UK

In this chapter, we outline some of the key aspects of the European aviation market.

While the UK was (and still, we stress, is for the moment) part of the EU, it is party to a number of key "market access" agreements:

— **Operations within the EU:** Under the terms of existing EU membership, any airlines "owned and controlled" by nationals of EU member states is free to operate anywhere within the EU with no restrictions. This allows UK airlines to fly from, say London to Madrid, but also from Paris to Berlin. Many airlines exploit this ability to keep asset utilisation high), and an example of how this works in practice is shown on the facing page;

— **Operations between EU and other key-markets:** The EU has a number of arrangements (known as bilateral agreements) with other territories, of which the key market is the USA, governed by the Open Skies arrangements. Other territories covered by such arrangements include Canada, and Brazil[9], with plans to negotiate deals with the likes of China, Turkey, the GCC states, and the ASEAN trading bloc.

On exiting the EU, four broad potential options have been discussed if UK-based airlines are to continue to fly within the EU, and we discuss these below:

i. Negotiate membership of the European Common Aviation Area (ECAA)

The European Common Aviation Area (ECAA) covers 36 countries (including the EEA states such as Norway), and extends the freedoms of the liberalised aviation market to each of its members.

The ECAA treaty is based on the principles of free market access, freedom of establishment, equal conditions of competition, and common rules including in the areas of safety, security, air traffic management, social and environment.

"Freedom of establishment" is defined under Article 7 of the treaty, and is likely to be of particular interest:

"…there shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an ECAA Partner in the territory of any of them. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms under the conditions laid down for its own nationals by the law of the country where such establishment is effected"

In other words: free movement of people is a key requirement for ECAA membership. As this is one of the key reasons why many in the Brexit camp wanted to leave the EU in the first place, it is likely to be a continuing thorn in the side of those wishing to simply enter the ECAA.

ii. Negotiate an "umbrella" bilateral agreement with the EU

Under option two, the UK would seek to negotiate a bilateral agreement with the whole of the EU. This has been done once before (with Switzerland), but was part of a much wider trade deal, and – crucially – required Switzerland to agree to the four fundamental freedoms of goods, services, capital, and labour.

iii. Negotiate a series of bilateral agreements with individual countries

If negotiating with the EU becomes too difficult or costly (in terms of concessions), then the UK can still try and negotiate with individual member states. It is likely, for example, that countries which benefit from inbound tourism from the UK would be amenable to a deal that keeps the visitors coming.

Although this sounds sensible, there are two potential problems (i) it assumes (and it is a big assumption) that the Commission will allow individual Member States to negotiate their own traffic rights; and (ii) although access between the UK and, say, Spain, may be relatively easy, the aviation world is governed by a series of rules (called the freedoms of the air) which govern onward connections and routings starting outside your country of registration. If a UK airline wants to fly between, say, the UK and Spain, then a bilateral agreement is needed only between those countries. If the airline wants to fly more complex routings, involving multiple countries, then the agreement of all of those other countries is required.

Therefore, what starts as a series of apparently straightforward negotiations (albeit with 27 countries in the EU, excluding the UK), turns – exponentially - into a spider's web of inter-related negotiations about freedoms and reciprocal traffic rights.

However, governments should not be discouraged from thinking about exploring bilateral (or indeed multilateral) agreements with those territories that are the most important to them.

Notes: (9) Yet to be implemented

iv. Obtain an operating licence from an EU member state

The fourth option is for individual airlines to seek to obtain an EU operating licence from an EU member state. Any airline with such a licence will continue to be free to operate flights taking-off and landing in the EU. Note however, that this does not solve the problem of flights between the UK and EU, but would (subject to the foreign ownership restrictions discussed below) allow EU subsidiaries of UK airlines to continue to serve other EU destinations.

Operating licences are granted by EU member states, i.e. countries within the EU. Conditions for granting the licence include that:

— the principal place of business is located in the member state;

— the airline must be more than 50% owned and 'effectively controlled' by EU nationals; and

— the airline holds a valid Air Operating Certificate (AOC) from the member state (usually granted by the regulator).

The first condition for the grant of an operating license could be satisfied relatively simply by setting up a subsidiary airline in the Member State. However, how this subsidiary is both 'owned' and 'effectively controlled' by a UK registered company will require some thought and careful structuring (noting, however, that there are numerous examples of airlines operating in the EU that have done this already).

Figure 9: The route map of a UK registered aircraft over a two day period, illustrating the flexibility afforded by the current market access agreements

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The granting of the AOC is, in principal, a competency issue, where the relevant national regulator is signing-off that the airline has the appropriate professional ability to ensure the safety of the operations. So while politics may come into play, the technical ability to obtain an AOC should not be insurmountable.

Taking this all into consideration, a likely contingency action may be for an airline to carefully choose an appropriate EU Member State that will grant an operating licence. Questions of foreign ownership (and politics) will need to be addressed, and some network reconfiguration (particularly on aircraft routings that do not simply depart and return directly to the UK) will be necessary.

As far as the final negotiating position is concerned, it is important to remember that the UK is not Norway or Switzerland, and that these "off-the-shelf" solutions are not likely to be the right answer. We believe that a bespoke option is the most likely, and that airlines from the UK, EU, and worldwide should be considering their lobbying positions within future negotiations and advocating "bright-lines".

Options outside of the EU

The position for UK airlines flying out of the EU will also require significant consideration. Consolidation of flying rights under the EU umbrella has formed a key part of EU Aviation policy that included the creation of the ECAA as discussed above. However, EU aviation policy goes much further, including: (i) the harmonisation of existing agreements between the Member States; and (ii) expansion of EU aviation policy by the creation of "comprehensive" agreements as discussed further below.

Harmonisation - Bringing existing agreements under EU law

Prior to the formation of the EU, each member state had its own bilateral agreements (known as Air Service Agreements, or ASAs) with every other country its airlines wanted to fly to. A significant task undertaken by the EU, therefore, has been to bring this proliferation of bilateral agreements in line with EU law.

A key reason for this was that the historical ASAs typically only allowed access to a third country by airlines registered in those countries (e.g. under a UK-India ASA, UK registered airlines obtain access to India, in return for Indian registered airlines having access to the UK). This ran contrary to a key concept of EU aviation law (in the example above, that a UK airline has favourable or discriminatory access to the Indian market, which is not afforded to airlines of other EU Member States).

The EU therefore attempted to amend historical ASAs of Member States, by either: (i) amending each bilateral ASA separately; or (ii) negotiating so-called "Horizontal Agreements" on behalf of the Member States which cover all existing ASAs with a particular third country.

According to Europa.eu, the EU had, as at the date of this document, concluded negotiations on over 1,000 bilateral agreements with 122 countries. This includes the conclusion of Horizontal Agreements with over 50 countries (i.e. there are 50 non-EU countries that have a pan-EU aviation agreement with the EU). The UK agreement with these 50 partners is therefore governed by EU law, and will have to be separately renegotiated or updated when and if "EU law" no longer applies.

Expansion – the creation of "comprehensive" agreements with global strategic partners

The EU has identified a number of key markets where arrangements that go far beyond the harmonisation stage. In these key territories, policy has evolved far beyond "open skies" market access, by means of liberalisation of ownership, regulatory convergence, competition, and passenger protection.

Of these agreements, by far the most significant to date is that signed with the United States, with further "comprehensive" agreements concluded with Australia, and Canada (and ongoing with Brazil and New Zealand).

For UK airlines (and consumers), the US agreement has fundamentally changed the market for transatlantic travel, and has led to a number of joint ventures (for example, between IAG – the parent company of British Airways, Iberia, and Aer Lingus - and American Airlines, and Virgin Atlantic and Delta) that are able to co-operate on capacity, scheduling, and pricing under anti-trust immunity granted as result of the EU-US agreements.

Unravelling these arrangements without significant pain and disruption to the consumer is unlikely, but there will certainly have to be negotiation between the US, EU, and UK authorities in order to agree to preserve North Atlantic traffic rights as they exist today.

In the future, the EU has plans for further agreements with other key territories, and it may be possible for the UK to leapfrog the EU in these negotiations. This will require agility and speed to compensate for the loss of bargaining power conferred by being a bloc of over 500 million people.

Obtaining airport slots

Whatever the legislative position on free market access, an airline's actual ability to fly into busy, capacity constrained airports is not guaranteed. Obtaining slots at busy airports is governed by EU legislation, which is itself guided by the IATA worldwide scheduling guidelines. In the EU, the relevant legislation came into force in 1993[10]. The processes – known as slot allocation – are complex and in some cases arcane, but in overview, the EU regulation aims to enforce the principles of neutrality, transparency, and non-discrimination. Slots are allocated by independent coordinators, and rules apply to both the maintenance of existing slots[11], and to the allocation of any new or 'recycled' slot. These rules have been subject to a number of reviews and revisions but concerns exist about the effectiveness of the allocation methods, particularly with regard to transparency and neutrality of the allocating bodies in each Member State. The rules are due to be replaced by the Better Airports Package, which, amongst other things will seek to clarify the position with regard to secondary slot trading (which is allowed in the UK, but prohibited in Spain, for example).

UK airlines may have concerns that the ability to obtain slots in EU airports is compromised following Brexit, either from a legislative or practical standpoint (although we note that the current legislation does not discriminate between EU and non-EU airlines)[12].

In the absence of legislation, the UK would revert to the IATA worldwide scheduling guidelines, which is an industry code of conduct, rather than legislation. Airlines that plan to fly to congested airports (rather than secondary airports) may wish to examine alternative options for the acquisition of slots, such as purchase of airline operations.

Finally, the potential impact of a long-awaited decision to expand airport capacity at Heathrow should be considered. A significant part of that equation is determining who pays for the expansion (through taxpayer's money, increased fees for passengers, higher landing charges etc.), and how new slots will be allocated to airlines. Existing EU legislation on slot allocation almost certainly wasn't designed to anticipate a step-change in capacity at such heavily congested airports. The stakeholders in this debate may want to use Brexit to consider options in this area.

What questions should airlines be asking?

1. To what extent does my operation and network depend on the ability to fly intra-EU, and between the EU and the UK? What aspects of the EU free market access must I be lobbying to protect?
2. What is my Plan B (and C and D) if we can't maintain business as usual? Are there things I can do now (AOCs, acquisitions, ownership structures, aircraft registrations) to help maintain my network and operations as close to cost- and revenue-neutral as possible?
3. Who is handling the negotiations on behalf of the EU and UK? Do they understand the implications of not getting what I need (as identified in Q1 above)? What can I do to influence that negotiation:
   a) What does my Plan B (and C and D) look like to the other side of the negotiation?
   b) How does that impact on UK and European jobs, and the wider economy?
   c) What negotiating leverage do I have (impact on tourism, jobs, Airbus vs. Boeing?)
4. How might alliance or joint venture partners of UK airlines be impacted by Brexit?
5. How might my competitors be impacted and what will their response be? Will their negotiating position be aligned with mine?
6. What deals might I want to review/change /strengthen with current airports? Are there any critical slots where I want to accelerate acquisition?
7. With regards to the announced expansion of Heathrow airport, what should my negotiating position be around issues such as slot allocation?

Notes: (10) Council Regulation (EEC) No 95/93, as subsequently amended.
(11) 'Use-it-or-lose-it' rights, broadly requiring slots to be used 80% of the time
(12) However, preference is given to new entrants who wish to fly EU routes.

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Retaining and improving customer relationships

The potential impact on customers is intertwined with the core issue of continued market access

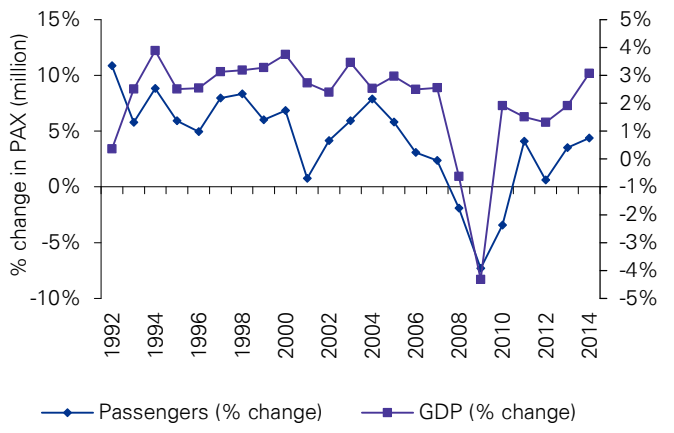
The potential impact on customers is tightly intertwined with the core issue of continued market access as discussed in the previous chapter: there's no point selling to French customers if you can't fly in and out of France.

But the impacts of Brexit on the customer also includes the impact on demand, competitiveness, convenience, consumer protection, and sales channel: these are discussed in more detail below.

Demand

There is a clear and established link between the wealth of a country, and the propensity of its citizens to travel. In general terms, as GDP per head increases so does the amount of air travel. The UK is no exception to this rule, although as is evident from the chart below, shock events (such as the Icelandic ash cloud in 2010, or 9/11) can dominate the impact on passengers in any given year.

Figure 10: Relationship between UK GDP and Air Passenger Growth



Source: CAA, Office for National Statistics and KPMG analysis.

However, within this broad relationship, the volume of travel also depends on factors such as: whether there are other viable transport modes, competition, the origin of travel and the reasons for travel in the first place. As examples:

— A UK airline and a European airline flying back-and-forward between Paris and Manchester ostensibly do exactly the same thing each day; however one sees the UK as an origin, and one as a destination. The price elasticity can be very different; and

— Business people, leisure travellers, and those flying to visit friends and family each have a very different price elasticity, and within each segment there is also a wide range of motivations and drivers: banking travel has a strong M&A related dependency, whereas those working for the oil majors travel less when the oil price is low.

However, what is clear is that although there is a wide range of economic forecasts, almost all predict some form of economic contraction (albeit some shorter term than others), which may indicate lower demand for air travel into and out of the UK. IATA predicts that overall, UK air passenger volumes may be down between 3 and 5% by 2020.

Costs and impact on competitiveness

The cost base of an airline is dominated by staff and fuel costs, and the cost of aircraft ownership.

The impact of foreign exchange on a UK airline's cost base is probably the most significant example of a Brexit impact that has actually happened. Prior to the disruption to the foreign exchange markets contemporaneous with Brexit approximately 40% of an EU airline's cost base (fuel and ownership expense) was denominated in US dollars. Just after the EU referendum date announcement, the GBP/USD exchange rate dropped to a 5-year low[13], and then post Brexit vote to 30 year historical lows.

To put this into context, our analysis shows that if the impact of (short term) hedging is ignored, then in order to recover the additional US$ costs alone, a return economy fare for a family of four travelling between Manchester and Orlando in summer would increase by about £250, a 5.8% increase on the ticket price pre-Brexit[14].

If this kind of price increase were pervasive across the industry, then applying generally understood (but not necessarily generally accepted!) income elasticity factors[15] would imply a reduction in demand of between 2 and 3%. Although this is much too high level analysis to be precise, it is at least consistent with the analysis produced by IATA which suggests demand reductions of between 1.7% and 2.9% caused by FX changes alone. We recognise, however, that there will be significant other factors at play here for individual airlines, with significant differences in short haul vs. long haul; business vs. leisure routes; extent of competition at key airports; and customer demographics.

Notes: (13) Daily spot rate reaching £0.7214 per US$, a 9.3% decrease against the average exchange rate for 2014 according to Bank of England's Interactive Database.
(14) Based on FX rates prevailing on 15 July 2016, and quoted ticket prices at 19 April 2016.
(15) http://www.iata.org/publications/economic-briefings/air_travel_demand.pdf

Convenience

Probably the most direct impact on passengers will be the impact on travel restrictions and security. It is possible that UK citizens may be impacted by more stringent visa and access restrictions, even separate queues at airports within the EU. We think that, acting rationally, most EU states will not seek to make travel significantly harder for leisure or business passengers following Brexit (on the assumption of reciprocal concessions from the UK Government). However it is possible that business travellers from the EU, EEA, and Swiss nationals may need permission of some form to travel to the UK for business purposes.

Outside the EU the picture is different. The EU "visa-reciprocity" agreement seeks to agree reciprocal visa-free visit rights between EU and non-EU countries, such as the US. Although the UK is not party to this agreement, the fact that the EU and US are currently involved in a very public dispute around reciprocity[16], could mean that the UK benefits from being further distanced from the EU in this area (although legally, nothing really changes, the UK might not find itself so far to the back of the queue as has been stated).

Passenger rights - airlines

While market access is probably the key factor influencing convenience, there are other areas to consider. Key to the customer's willingness to travel is the comprehensive system of air passenger rights introduced by the EU since 2004. Since this time, increased consumer awareness of these rights has led to increased claims, and a number of court cases giving more clarity over the circumstances under which claims can be made. In some cases, airline companies and tour operators have expressed a view that the balance of protection has swung too far in the direction of the consumer, with particular reference to the European Court of Justice (ECJ) rulings about 'extraordinary circumstances' exemptions (which allow airlines to avoid paying compensation for events they deem outside of their control) and the time-limits to bring claims.

KPMG's analysis suggests that UK based airlines are holding well over £200 million on their balance sheets to account for possible claims under the EU's delayed passenger compensation rules (EU 261). This is clearly an area in which the UK could seek to amend its policies, but the ability to do so will depend on both the political willingness to reduce UK consumer protection to below those offered to the EU-27, and the EU's negotiating stance on the rights afforded to its citizens travelling on UK registered airlines. However, there is no doubt that many in the industry believe that EU 261is ripe for reform, and Brexit may provide a catalyst to do that.

Passenger rights – tour operators

The Package Travel Directive (PTD)[17] requires package tour operators to provide refunds and facilitate repatriation of passengers in the event of the failure of the tour operator. In the UK, this is implemented through ATOL (and managed by the CAA), although as with much other EU legislation in transport, the ATOL scheme pre-dated the PTD, having being in existence since 1973. It seems unlikely that a UK Government would want to significantly relax any of the consumer protections offered by the existing ATOL scheme. As such, the fees, compliance, and bonding requirements currently imposed on UK tour operators is unlikely to be changes significantly.

Route to market

Historically, airlines were heavily reliant on computerised reservation systems (CRS) to distribute their inventory through travel agents, which drove the first major EU legislation in this area in 1989. The initial aims of this legislation were to avoid abuses of market power, as at that time many of the CRSs were owned (or significantly influenced by) partner airlines.

However, with the advent of the internet as a viable sales channel it is estimated that the number of direct bookings overtook traditional channels by 2011[18], and the ownership structures of traditional CRS operators had also changed significantly. Therefore the new legislation introduced in 2009[19] relaxed some of the original restrictions. The key aspects of this legislation (from an airline and passenger perspective) include:

- Prices displayed must be consistently presented (i.e. inclusive of 'unavoidable' charges such as taxes and fees)
- The ranking of fares is to be non-discriminatory;
- Protection of personal data; and
- For other modalities (such as rail) to be displayed.

The legislation applies to any CRS "in so far as it contains air-transport products, when offered for use or used in the Community"[20]. In addition, the legislation requires the equivalent treatment for Community air carriers, where the CRS provider operates outside the EU (i.e. it can't discriminate against an EU carrier in a third country if it wants to operate in the EU).

Notes: (16) http://www.travelweekly.com/europe-travel/visa-reciprocity-issue-with-europe-could-have-dire-consequences
(17) EC 80/2009
(18) Fitness check – Internal aviation market, EC Staff Working Document, 2013.
(19) Regulation 80/2009 on a code of conduct for computerised reservation systems
(20) Article 1

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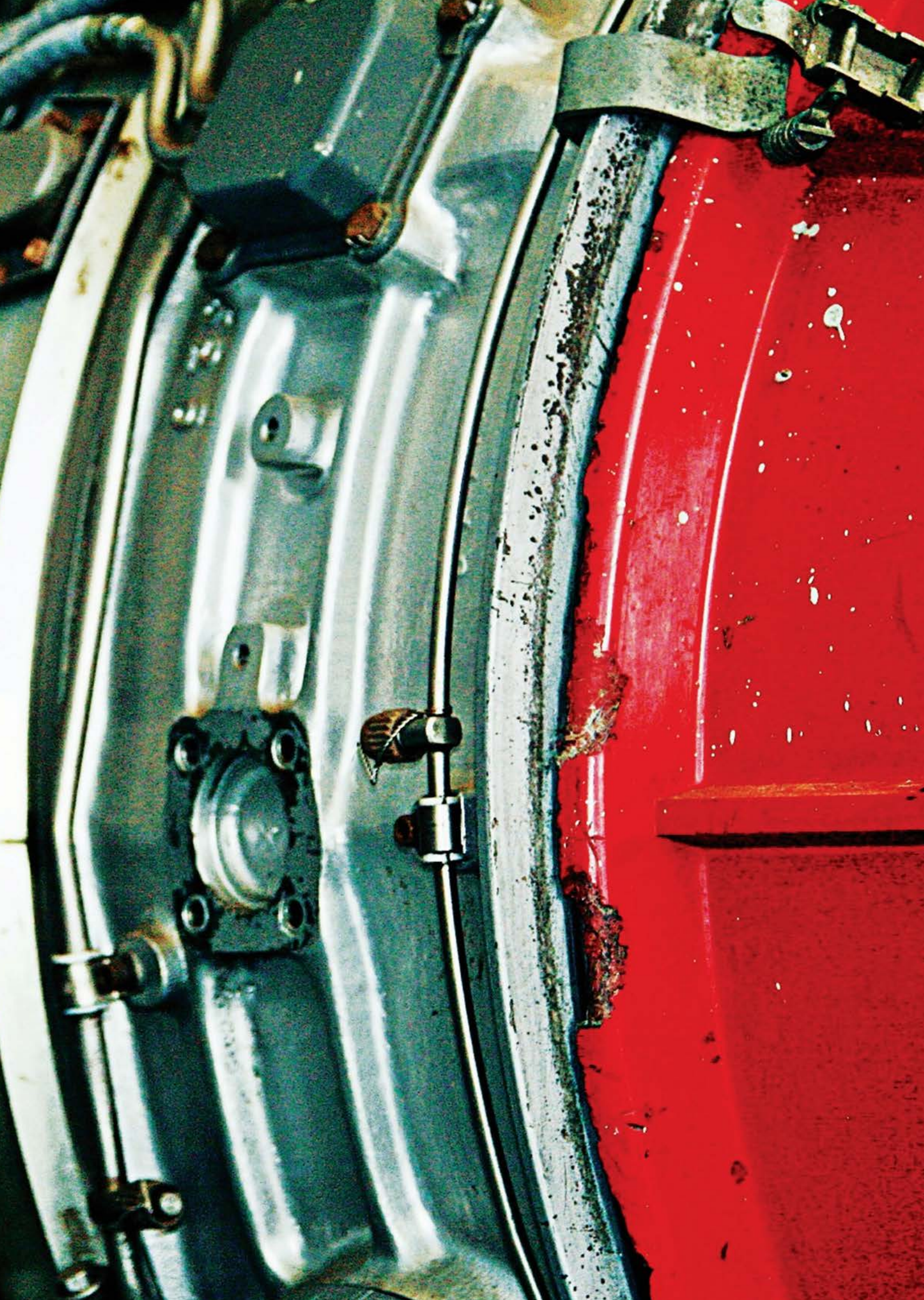
As such, it would seem that the best outcome of any renegotiation in this area will be for UK carriers to be continue to be treated in a non-discriminatory fashion when selling tickets via CRSs in the EU. There does not seem to be any scope for UK carriers to negotiate advantageous terms compared to the position today.

What questions should airlines be asking?

1. What is the geographic split of my customer base, and how much might they be impacted by GDP and FX changes?
2. Are there any overseas markets that may view the UK as relatively more attractive as origin traffic? How do I market and sell to them?
3. Who are my passengers, why are they flying, and how might their demand be impacted as a result of Brexit?
4. How might my competitors be impacted by Brexit, and what is their ability to absorb the impact of cost increases?
5. What are the key airports we fly to and from, and what are their contingency plans for security and airside configuration changes that might be required?
6. What is my lobbying position with regard to passenger compensation? Can I make positive PR statements to protect these rights regardless of legislation?
7. What is my route to market, and what discussions should I be having with my GDS providers?
8. How should I adapt my customer experience strategy to overcome any convenience issues (perceived or real) as a result of Brexit?



Looking after your people

Aircrew are subject to very specific regulations and these should be considered carefully, alongside impacts on your wider employee base

Immigration and right to work in the UK

Airlines often employ flight deck and cabin crew of different nationalities, both in the UK, and in bases overseas (including the EU).

The rules on right to work in the UK (for those currently in the UK) are complex, and are likely to evolve over time. As at the date of this document, the UK Government has not made any firm commitment to the rights of EU nationals currently in the UK. It is likely that the final rules will be formed as part of reciprocal negotiations to allow for UK citizens working and living in the EU to remain where they are.

KPMG has produced a one-page flowchart that helps understand this complicated area. This can be accessed by registering for the EU referendum portal (https://kpmgeuref.online-event.co), and accessing the People & Migration section. While the final rules are still unclear, HR departments should be examining their recruitment, retention, and relocation policies, as well as understanding any operational impacts caused by any restrictions on free movements of labour (including the ability to recruit critical skills from a potentially smaller pool).

Personal taxation

Brexit will have little impact on the personal tax obligations of employees in the airline industry (because the UK already has comprehensive Double Tax Treaties with all EEA Member States), however there will be a potentially significant impact on social security for aircrew.

Social security - general

EU Social Security Regulations were introduced to encourage individuals to be mobile and work across the EU without having to worry about needing to pay social security in every country in which they worked (as this would act as a disincentive to free movement).

The fundamental rule is that individuals should pay social security contributions in one member state at a time (i.e. in contrast to personal tax liabilities).

The impact of the regulations is to avoid not only an additional expense for employers and employees but also fragmentation of social security contribution records for the employee and their family (given that social security contributions secure rights to various state benefits).

Aircrew are subject to specific regulations as discussed below. For other employees, airlines will need to consider the impact on their workforce. For example, if management are required to travel to the EU regularly (which may be a requirement of the AOC if staff are "borrowed" from UK HQ into a European subsidiary), then the rules may become more onerous and complicated.

Social security - aircrew

Since 2012 aircrew have been subject to a special rule: they are subject to social security contributions in the member state where their designated home base is situated. Prior to 2012 crew who were in post at that time could apply to be covered by the new rule or continue under the old rule for a period of 10 years.

A "home base" is defined as the place where the employee normally starts or ends his or her period of duty and where the operator is not responsible for the employee's accommodation. This may be the member state of residence of either the employee or the employer, or indeed a different member state entirely.

For example, a UK resident airline with a population of crew based in Germany will be required to register for and pay German social security contributions, regardless of where each crew member is actually resident.

Currently, EU regulation allows social security contributions to be enforced cross-border – in the example above if the UK Company has no corporate presence in Germany and does not comply, then the relevant authority in Germany may request that HM Revenue & Customs should collect the contributions from the company in the UK, and remit them to Germany.

We assume that the current EU regulations will continue to apply during the 2-year Brexit negotiation period, and that some form of transitional rule will be agreed.

However, it is possible that the basing rule described above will ultimately cease to apply to UK nationals, thus leading to a fragmentation of coverage across multiple member states and a consequent multiplication of compliance obligations for the employer.

What questions should airlines be asking?

1. What is the nationality and residency status of my employees?
2. How much do I rely on freedoms of movement within the EU to run my operations as they stand today? What contingency plans do I need?
3. If employment from the EU becomes an issue, where are the key skills shortages likely to arise?
4. How do I communicate with and reassure employees during this time of uncertainty?
5. Do I need to re-assess my current recruitment and training policies?
6. What might the cost of aircrew social security fragmentation be, and how is this being handled in negotiations?

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Strengthening your brand proposition

There are number of different airline ownership operating models, with different implications for brand and proposition

Within this mix, there is also the distinction between so called "legacy" (or full service) carriers (FSCs), and low cost carriers (LCCs), and in many cases airline groups can contain a mixture of both.

The important point is one of brand perception and consistency: a customer buying from Vueling may expect a very different experience from British Airways, although both are part of the IAG Group.

So what does this mean for European airlines? We look at this through four lenses: operational, reputational, marketing, and cost:

i. Operational

Arguably, for those airlines that already operate common branding, the operational impact should be limited (i.e. if an airline needs to change where its aircraft are based and/or registered in order to maintain its network then having a common brand is helpful).

However, airlines that operate multiple brands and propositions have reduced flexibility around re-basing their aircraft because they need the right brand in the right place.

ii. Reputational

Airlines will need to assess whether – outside the UK - their brand is viewed a primarily local or European brand, or a UK-centric brand. It remains to be seen whether there is any-UK sentiment from the European, or indeed global, consumer in their airline selection, but perhaps a more obvious response is how marketing and brand awareness spend is diverted.

iii. Marketing approach

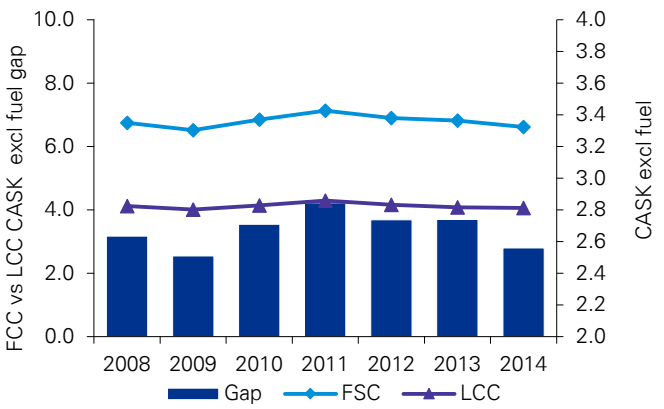
Just as there is a distinct origin and destination airport in any airline journey, there are different markets to address at each end. The extent to which airlines generate revenues from both ends of their markets (and the amount of marketing spend to generate brand awareness in each) differs significantly. However, with sterling weak, the UK as a destination becomes cheaper, and as such airlines may find they need to divert more spend to the traditional "destination" end of the journey.

iv. Importance of cost as part of the proposition

In the short-haul market a key factor in the astonishing expansion of the LCC market post-liberalisation was the creation of new markets: quite simply the low price point made the route a viable proposition (prior to this, the concept of a "secondary" airport 30 miles outside the city as a destination was simply not contemplated).

As the market evolved, the LCCs and FSCs have somewhat converged their propositions (particularly in the economy cabins), as both the product offerings and price-points have become closer (see figure below). This has simply acted to make the market in European short-haul more competitive.

Figure 11: Total operating cost excl. fuel FSC vs. LCC (US$ cents per ASK)



Source: Airline Analyst, and KPMG analysis

In long-haul, price may be less of a factor, as there are other considerations such as quality of hard and soft product, network, and exiting loyalty affiliations to consider. However, being more expensive is never helpful, and the situation may be made worse if and when oil prices rise back towards historical levels.

As we discuss above, the cost-base of UK airlines has increased simply as a result of foreign exchange rates, as long as this weakness in sterling persists airlines unit-costs will be less competitive than pre-Brexit.

Ancillary revenues

The generation of ancillary revenues (that is, revenues that are not just the cost of the seat) has been – and continues to be – a core part of the LCC brand proposition, and FSCs are catching up fast. Airlines will need to assess both their ability (for regulatory, legal, or territorial reasons) to sell these products, and the attractiveness of the offering.

In relation to "on-board" products, the only significant impact may be driven by any changes in duty free legislation (the ability to sell duty-free on intra-EU travel was abolished in 1999).

However, other products do require more thought, in particular, those ancillary revenues that may be subject to financial, or other, regulation, such as:

— The sale of travel insurance (or missed connections insurance), which is usually – but not always – as an Appointed Representative of a primary insurer or underwriter;

— Arrangements with respect to branded and co-branded credit cards; and

— Foreign exchange services (including travel money and prepaid foreign currency cards).

The current EU regulatory and legislative environment for financial services in some ways mirrors the aviation industry. The concept of the financial services "passport" essentially means that an entity permitted to provide, say, insurance services in one country by virtue of being authorised and regulated by the regulator in that member state, is also able to provide those services in the rest of the EU (rather like the granting of an operating licence in on member state allows flying in and between any other member state).

As a minimum, airlines should be using this as an opportunity to ask their key suppliers, such as underwriters, what their contingency plans are in order to be able to continue to sell to the wider EU. In addition, airlines may usefully use Brexit as an opportunity to review their relationships with key suppliers like insurers. As an example, the FCA wrote to key insurers on 26th July 2016 to notify them that they were unhappy with some of the ways that they were working with, monitoring, and governing their Appointed Representatives (which includes airlines). The outcome of this review may have implications for the airlines, and Brexit may prove to be a useful renegotiation tool.

In addition, there are certain other aspects of products related to financial services to consider and/or keep under review, for example:

— Credit card fees: airlines (like other companies) are prohibited from profiting from credit card transactions; and

— "Pre-checked" selling: EU legislation prohibits the selling of add-on's via pre-checked forms.

What questions should airlines be asking?

1. What is the price sensitivity of my markets, and to what extent can this be compensated for by promoting inbound tourism/business travel market share?

2. How might my competitors react, and what is their ability to react (with reference to their own markets, cost bases, and balance sheet strength)?

3. If there is a permanent shift in competitiveness, do we need to consider changing business model, target markets, or longer term cost-saving measures?

4. Will my ability to sell ancillary revenues be impacted? What questions and assurances should I be asking my suppliers (e.g. primary insurers)?

5. How is my brand perceived in Europe? Can this be used to our advantage?

6. Will any of my other key ancillary revenue contracts be impacted (for example, with hotel chains, car hire companies)?

7. In respect of regulated products:

i. What, if any, regulated products are they selling, and who is the regulator (as an example, the provision of Bureau de Change services is actually regulated by HMRC)?

ii. Does the airline have regulated permissions to sell on its own behalf, or (more commonly) as an authorised agent or representative of another party?

iii. Where the airline sells as a representative of another party (for example, an insurance underwriter), what jurisdictions is that 'primary' party allowed to sell in, and what will/might change post-Brexit.

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Optimising core business processes

Airlines need to closely monitor regulatory changes around ground handling, airport charges and emissions trading to optimise core business processes

Ground handling

Ground handling services (GH) are essential to airline operations, and typically represent between 5-10% of operating cost. GH covers areas such as maintenance, refuelling, check-in, catering, baggage handling and transport within the airport perimeter. Historically, GH services at EU airports were monopolistic in nature, however since 1997, the provision of GH services in the EU is covered by legislation that opens the market to competition[21]. Certain airlines provide in-house GH services for themselves, which is known as 'self-handling'.

Within the EU itself (excluding the UK), it would seem unlikely that UK airlines flying to EU airports will experience any significant change.

In the UK, the CAA is responsible for the implementation of the relevant regulation at UK airports as follows:

— For third-party handling: applies to over 2 million passengers per annum (or more than 50,000 tonnes of freight per annum).

— For self-handling: applies to airports handling over 1 million passengers (or 25,000 tonnes of freight).

In practice, the key debate is whether, and to what extent, the number of third-party handlers can be restricted to the minimums imposed by the EU (minimum of one or two[22] depending on the nature of the service). There are safety, infrastructure capacity, administrative, and commercial considerations that feed into this argument, and often the aims of the stakeholders are competing. The airports captured by the legislation are set out below, based on CAA data for 2015:

Table 1: Traffic at UK airports in 2015

Traffic at UK airports in 2015	
More than 1 million passengers or 25,000T freight	**More than 2 million passengers or 50,000T freight**
Heathrow	Heathrow
Gatwick	Gatwick
Manchester	Manchester
Stansted	Stansted
Luton	Luton
Edinburgh	Edinburgh
Birmingham	Birmingham
Glasgow	Glasgow
Bristol	Bristol
Newcastle	Newcastle
East Midlands	East Midlands
Belfast International	Belfast International
London City	London City
Liverpool	Liverpool
Aberdeen	Aberdeen
Belfast City	Belfast City
Southampton	
Cardiff	

Prior to the Brexit decision, in May 2016, the CAA had already published a consultation document[23] to gather evidence about the effectiveness of their role in implementing the regulation, particularly in the context of the discretionary powers handed to them under that legislation.

In this context, UK airports, airlines, and ground handlers should consider whether both the implementation of the existing regulations as contemplated by the CAA, and the regulations themselves, should be amended. For example, airlines may consider whether the extent to which they are able to self-handle is worthy of review.

Airport charges

Airlines pay airports for the use of their facilities in the form of charges for services such as landing fees, passenger processing (check-in, boarding), and cargo handling. Charges are often levied on take-off, and landing of aircraft and based on the number of passengers and aircraft type and weight. For UK airlines, these charges averaged approximately 10-15% of their direct cost base in 2015 based on analysis prepared by KPMG.

EU rules in this area were implemented in 2009[24], and apply to any airports in the EU handling more than five million passengers per year, and to the largest airport in each Member State. Not all airport charges are covered by the legislation, with the significant exceptions being PRM, security, navigation/ATC, ground handling, baggage charges, and local taxes.

The rules (the effectiveness of which are under review), seek to adopt three core objectives:

— **Transparency:** the requirement to share a detailed cost breakdown with airlines to justify their charges;

— **Non-discrimination:** broadly, all airlines receiving the same service should pay the same charge. However, airports can differentiate between airlines as long as the criteria are "clear and transparent", and on environmental grounds (aircraft with less equivalent fuel burn, noise, and emissions can be charged less)

— **Consultation:** a system of mandatory consultation between airports and airlines becomes mandatory, and an independent supervisory authority is established to help settle disputes.

Notes: (21) Directive 96/67/EC, implemented in the UK by means of the Airports (Groudhandling) regulations 1997, and Airports (Groudhandling) (Amendment) regulations 1998
(22) One in the case of certain services
(23) http://publicapps.caa.co.uk/docs/33/CAP%201409%20MAY16.pdf
(24) Directive 2009/12/EC

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For UK airlines flying to EU destinations, the key concern may be that if the directive no longer continues to apply, then airport charges could be levied on them in a discriminatory way. The ability of the UK airline to "retaliate" with reciprocally high charges to EU airlines would be limited by the commercial objectives of the UK airports (and in the case of regulated airports, the pricing frameworks adopted by the regulator).

UK airlines flying to the EU should seek to establish their commercial importance, and negotiating leverage in respect of those EU airports to which they fly.

Within the UK, the CAA interprets, monitors, and enforces the obligations on airports covered by the regulations in accordance with the Airports Charges Regulations 2011. In 2016 and 2017, the airports covered by the CAA's powers (by virtue of exceeding the five-million passenger threshold) is as shown below. It remains to be seen whether the UK would continue to require the implementation of the EC directives as they stand, but it is unlikely that any truly discriminatory practices to non-UK airlines will be adopted, especially as all of the airports captured by the directive are privately owned by commercial operators who are incentivised to maximise returns for their shareholders.

Table 2: UK airports covered by Directive 2009/12/EC (2016 and 2017)

UK airports covered by Directive 2009/12/EC (2016 and 2017)	
Heathrow	Edinburgh
Gatwick	Birmingham
Manchester	Glasgow
Stansted	Bristol
Luton	

Environmental – Emissions Trading

Since the start of 2012 emissions from all flights from, to and within the European Economic Area (EEA) are included in the EU emissions trading system (EU ETS). Airlines receive an allocation of allowances, but must purchase any additional allowances from the market.

The legislation adopted in 2008 applies to EU and non-EU airlines. In the period 2013-2016, only emissions from flights within the EEA fell under the EU ETS to allow time for further negotiations, particularly to accommodate objections from non-EU countries.

In the UK, the original Directive[25] was implemented via the Greenhouse Gas Emission Trading Scheme Regulations 2012. Up to 2016, responsibility for delivering EU-ETS policy within the UK rested with the Department of Energy & Climate Change, which managed the government's overall statutory obligation (set out in the Climate Change Act 2008) to reduce the UK's carbon emissions by 80% from their 1990 baseline.

However, on 14th July, the UK's new prime minister, Theresa May, announced the abolition of DECC, with the department merged into a newly formed Department for Business, Energy & Industrial Strategy. Some commentators have suggested that this may indicate a softening of the UK's stance on climate change, and does throw into question which department will be handling the Brexit negotiations in this area.

Outside of the EU, airline emissions trading has been the subject of ongoing debate, with both the US and China objecting to their inclusion in the EU scheme, and many commentators discussing whether regional schemes can ever be made to work at all. On this note, the incoming Director of IATA, Alexandre de Juniac, remarked "If we have a system of taxing carbon emissions, it's got to be global — it's got to be applied across the board, not so that some zones pay and others don't. You can't have a system that penalizes some airlines and not others".[26]

On 26th September 2016, the International Civil Aviation Authority (ICAO, an agency of the United Nations) hosted a world aviation forum. ICAO has committed to get all of its 191 members to agree to a market-based mechanism to cope with emissions trading at the assembly.

Therefore, the UK, European, and International picture with respect to emissions trading and ETS is, at best, somewhat cloudy. Airlines should consider their position in this regard both in terms of continued competitiveness, but also their wider CSR responsibilities and brand image.

Notes: (25) 2003/87/EC
(26) Bloomberg Businessweek, 7 April 2016.

What questions should airlines be asking?

1. What are my key Ground Handling relationships, and how might these be impacted?
2. Do I have any concerns about GH costs at particular airports, and is this an opportunity to lobby for change?
3. Is the acquisition of certain airport slots a key part of my strategy? Do I need to/can I take action prior to any potential changes to EU slot allocation rules (e.g. by acquisition)?
4. What are the key terms of my airports contracts (e.g. remaining tenure, indexation, currency)? Is now a good time to renegotiate?
5. What is my external position with regard to ETS and climate change charges? What is my lobbying position with UK and European parliaments?

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Adopting an appropriate group structure

As regulatory and legal changes unfold in the coming years, current group structures may no longer be the most appropriate

Group structures

Airline group structures come in five broad types of operating model, each with very different brand propositions, and underlying operating models.

The organisational structure is designed to facilitate brand and network strategy, and also the airlines approach to procurement and cost benefit (for example, heavy reliance on outsourcing or in-house service companies providing services to the "group").

Table 3: Airline group structures

Model	Description
1. Stand-alone: single brand	Genuinely stand-alone operations, operating under one brand. UK examples include easyJet, Monarch, and flyBe.
2. Stand-alone: multiple brands	Stand-alone operations operating a number of brands. A good example of this model is Norwegian airlines: — Norwegian Air Norway - Norwegian AOC operates within Scandinavia — Norwegian Air Shuttle - Norwegian AOC operates outside Scandinavia — Norwegian Air International - Irish AOC, based in Dublin — Norwegian UK - British AOC, based in London
3. Integrated with Tour Operator (TO)	Airlines integrated into a wider TO group, with those airlines providing the majority of the lift for the TO. The airlines (and sometimes TO itself) often market "seat-only" packages where they are in direct competition with other airlines. Thomas Cook and TUI are the major players operating with this model. Both run a number of regionally focused airlines, albeit with increasing levels of integration
4. Equity stake	A model pioneered by Abu Dhabi's Etihad airways, involving an "equity alliance" of minority stakes. The stated rationale is (i) to provide feeder traffic into long-haul operations; and (ii) to provide synergies and procurements benefits. Air Berlin and Alitalia are EU airlines that are part owned by Etihad.
5. TopCo over multiple brands	This structure entails a holding company owning a number of operating companies (airlines, and related services companies such as maintenance), each with distinct brands and products offerings. Examples of this model includes IAG (British Airways, Iberia, Vueling, and Aer Lingus); and Lufthansa Group (includes LH, Austrian, Swiss, and Eurowings amongst others). In many cases, there has been a desire to keep brands separate, with each airline maintaining its own AOC, aircraft, and customer-facing workforce, while trying to drive out synergies from back-office, procurement, and shared services functions.

Airlines should start to examine the potential impact on their current structures of Brexit, with regard to brands, people, network, and operational issues outlined earlier in this document.

Captive leasing arrangements

Airlines often enter into tax efficient structures for leasing aircraft. Often, this will take to form of an asset leasing company set up in a jurisdiction with lower corporation tax rates, which then leases the aircraft back to the operating company.

Although there is unlikely to be any significant change in the ability to enter into these arrangements as a result of Brexit, there is a possibility that future British governments consider lowering of UK corporation tax rates to provide a boost to the economy.

What questions should airlines be asking?

1. To what extent does the network and schedules operated require interchangeability of aircraft and flight crew between UK and EU bases, and between companies with different AOCs? What are the potential contingency plans, and how might this impact on revenues and cost?
2. Does the achievement of any planned or announced synergy targets depend on permissions granted as part of being in the EU (for example, the ability to move people or assets)?
3. How might the way the company manages regulatory compliance be impacted post Brexit?
4. Within the current group structure, might there be any "foreign-ownership" issues, and are there any structuring options available to deal with this?

Improving operational and tech infrastructure

Is it possible that Brexit has created opportunities to re-assess operational and technology related strategies, or allowed the acceleration of change?

UK airport capacity

The UK has had a painfully protracted debate about the need for, and location of new airport capacity, particularly in the South East of England.

For the UK economy, the ability to trade in a post-Brexit environment will depend on getting more connections to the fastest growing parts of the world.

KPMG's analysis shows that unless more airport capacity is provided, more of those cities – the growth engines of global trade - will be out of direct reach (Figure 12). It is possible, that the impact of Brexit will re-focus government attention in this key area as the UK seeks to re-shape its trading relationships with the world.

The potential availability of new capacity in the UK, and the potential for access to new slots (as discussed previously) would be a key change to key European airport infrastructure. Airlines (and airports) will want to consider how Brexit changes their strategy, and ability to execute on that strategy in this key area.

Back-office operations, outsourcing and shared services

As part of measures to improve efficiency and reduce costs, a number of airlines have outsourced their back office operations (and set up shared services centres) in countries outside their head-quarters. In some cases the location of the shared services centre is within the EU, often in places with relatively low labour costs, but with a high level of skills.

Airlines will want to assess whether their current set-up is "Brexit-proof". However, it is also possible that the impact of Brexit has created opportunities to re-assess strategy in this area or to accelerate plans to further outsource and/or offshore services – often to maximise cost efficiencies. KPMG's Outsourcing & Shared Services practice is seeing an increase in the marketing of incentives to encourage foreign investment from typical EU offshore locations (such as central Europe) to counter similar activity from offshore countries further afield in Asia and the ASEAN region. Finally, the EU may become a less attractive destination if we approach Euro parity and there may be opportunities to 'near-shore' services in low cost delivery locations within the UK.

Some outsource providers have also been impacted by the adjustment in foreign exchange rate for sterling based contracts where the cost base is in euros or dollars and this may prove to be problematic some services, particularly high volume transition processing deals where margins are typically low.

Management Information and IT systems

The risk management exercise associated with Brexit has put more pressure on key business functions to provide information and metrics to help the business to assess and impact potential Brexit scenarios. What this exercise is highlighting is the reliance on effective data management and having agile IT platforms to be able to manage any Brexit remediation activities as and when they are identified.

Data protection and security

Airlines are required to manage and store a huge amount of personal data, including booking and payment details, passenger name records (PNRs), and immigration data that may be required by the country of destination (for example, Advance Passenger Information in certain territories such as the US requiring both passport data and details of residence during the stay).

In addition, airlines increasingly look to their customer databases and loyalty scheme databases to provide a progressively more personalised travel experience, and as a platform for targeted marketing. Knowing the customer also involves using data made available from unstructured sources such as social media.

One of the most important regulations governing the security of data is the EU General Data Protection Regulation (GDPR)[27]. This regulation places significant and complex requirements around the way a company collects, uses, stores, discloses and disposes of personal data (including passenger data). It comes into force in May 2018 (well before any UK exit from the EU) and has a cross-territorial impact, where an organisation provides "information services" (i.e. internet based services) to EU nationals, then they are required to process those Therefore, all airlines operating flights to and from the EU fall within the scope of this and regardless of Brexit will need to comply with GDPR.

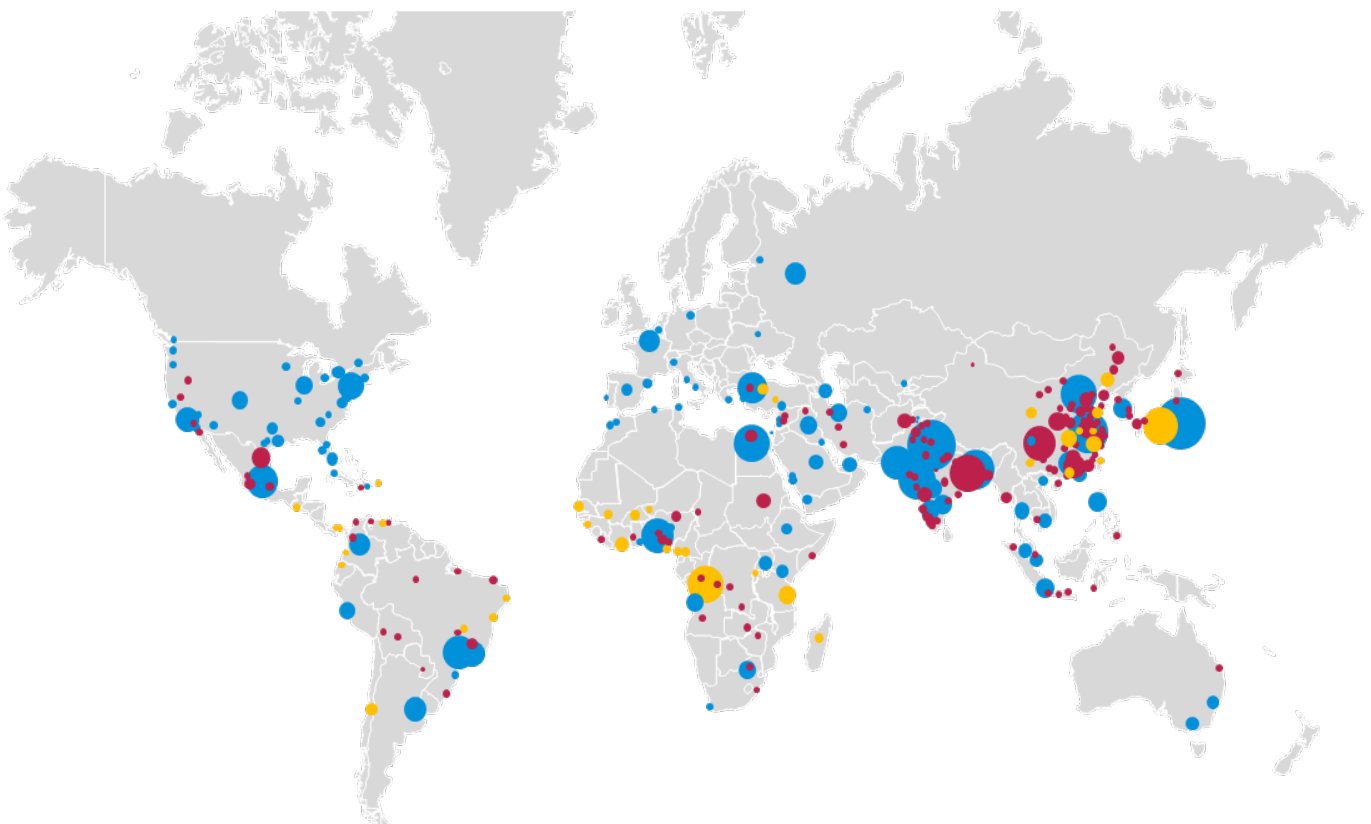
The UK will as a minimum be required to operate an "adequate Data Privacy ecosystem" comparable to the GDPR in order to allow it to do so, and airlines should monitor the negotiation between EU and UK in this regard.

Notes: (27) http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0679&from=EN

What questions should airlines be asking?

1. Is my shared-services strategy dependent on the UK's current relationship with the EU? Are there better deals to be made further afield?
2. Does my shared-services strategy need updating in the light of Brexit? Is this an opportunity to revive plans that were previously deemed too politically difficult?
3. Do I understand the volatility in my supply chain for key transaction services that are outsourced?
4. Can my IT systems keep up with the pace of change?
5. How prepared am I for GDPR?
6. Does my IT investment and procurement strategy need to change as a result of Brexit?

Figure 12: Missed connections: where you can fly to from London



Dots refer to size of population in 2030. Only cities of more than 2 million people noted.

Key:
- Cities served by direct flights from London
- Cities not currently served by direct flights from London
- Cities not served by London but by another European hub airport

Source: CAPA – Centre for Aviation, UN World Urbanization Prospects: The 2014 Revision, USDA ERS International Macroeconomic Data Set.

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Staying informed on risk and taxation changes

Can tax be used as a mechanism for reducing cost and pricing pressures resulting from Brexit? How will the risks that your suppliers face affect you?

Corporate taxation

Corporation tax is administered on a member state basis, and through a network of bilateral treaties, and in most cases is unlikely to be directly impacted. The aviation industry is subject to specific internationally agreed rules which will also remain in place. However, EU and EEA members do benefit from a number of directives that facilitate the cross-border movement of capital and income, for example the merger directive and the parent-subsidiary directive. If the UK leaves the single market then UK companies are likely to lose access these unless they restructure. UK government policy may also change as it seeks to re-assure investors that the UK continues to be an attractive place to do business.

Transfer pricing

Transfer pricing (allocation of profits within the EU) is governed by national legislation, treaties and the OECD guidelines, but EU companies also have access to binding arbitration through the arbitration convention, which requires member states to come to an agreement if there is a dispute. On exiting the EU, this requirement will drop away, and may expose airlines to more prolonged disputes.

Air Passenger Duty (APD)

APD is set and levied by the UK Government, and is not bound by any specific EU legislation. Since it was introduced in 1994, APD has raised £28.5 billion for the Treasury, and the UK has the highest levels of tax on air passengers, (in the form of APD), in the world[28].

The rules on APD might be an area where government can adapt its policy to counteract some of the cost and pricing pressures discussed previously. Airlines might wish to consider their lobbying position in this regard, and to update or prepare assessments of the impact on jobs and the economy of air transport in the UK.

Finance and treasury risk

The longer implications for debt availability, treasury, derivatives, and currency clearing are the subject of significant uncertainty across all industries, and KPMG's financial services team will be providing updates (logon and register at: https://kpmgeuref.online-event.co). Airline specific material will also be updated on the transport portal.

In the short to medium term, airlines should be examining their exposures (FX and fuel), and revisiting their medium term planning assumptions. In particular, they should be looking at the hedging positions of their competitors, and seeking to determine if there are opportunities in the short-term arising from their relative hedging positions.

Supply chain risk

Apart from the direct threats to the business identified elsewhere in this document, airlines should also examine the potential impact on their supply chain for resilience to Brexit. Even in "normal" times, supply chain disruption has caused issues for airlines with even the strongest balance sheets. Of particular interest to airlines will be:

- Outsourced MRO operations;
- Ground handling and catering providers;
- Key IT suppliers and data centre resilience;
- Outsourced transactional processing arrangements;
- Arrangements with hotels and holiday providers;
- Alliance airlines (those supplying a significant portion of feeder traffic)
- Airports;
- Lessors; and
- Training, regulatory compliance, and certification providers.

Supply chain/organisation redesign opportunities

Airlines work in a complex, cross-border, regulated environment with organisational structures that have evolved over time to meet those needs.

KPMG has worked with many industries to improve the efficiency, resilience, and tax benefits of their supply chain. In the case of banking, for example, there has been much reorganisation of organisational structures (as a result of regulatory challenges) that have presented both opportunities and risks to the business. Airlines should consider if there are any opportunities (that might previously have been deemed too-difficult) to use Brexit as a catalyst to re-examine their corporate structures and supply chain.

Notes: (28) Source: British Air Transport Association

What questions should airlines be asking?

1. What are our key transfer pricing arrangements between UK and EU territories?
2. Who are our most significant suppliers, and how might they be impacted by Brexit?
3. Does Brexit present an opportunity (or requirement) to move assets, people, IP, or processes, and how do I design a tax-efficient supply chain?
4. What is my current hedging position, and how does this compare to my competitors?
5. What are my foreign currency cash-flows, and how might any changes in business strategy impact this?
6. What is my lobbying position with respect to APD?

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