

EXECUTIVE SUMMARY

The air transport sector is essential for the economic and social cohesion of the extra-peninsular territories, given that, for routes connecting these territories with each other or with the peninsula or other international destinations, there are no real transport alternatives that offer similar conditions in terms of immediacy and frequency. Therefore, there are various measures in place to support the connectivity of the autonomous communities of the Balearic Islands and the Canary Islands and the autonomous cities of Ceuta and Melilla. These aim to facilitate air transport for the population of these regions, compensate for their peripheral geographical situation with respect to the rest of the country and foster their social cohesion and economic development.

Among them is the partial discount on plane tickets for residents of the archipelagos and autonomous cities on direct scheduled routes between these territories and the rest of the country, as well as for inter-island travel.¹

It consists of a 75% discount on airfare² that is applied directly to passengers on tickets issued by airlines. The airlines then submit settlements for the discount coupons flown to the Directorate-General of Civil Aviation of the Ministry of Transport, Mobility and Urban Agenda (DGAC). Once these are verified, payment is then made to the airlines.

The fare discount system coexists with other aid for air transport, notably public service obligations (PSOs).³ PSOs may consist of continuity, regularity, capacity or price obligations. Such obligations may only be imposed in the case of services which operators would not provide on the basis of their commercial interest and provided that they are necessary to ensure the service or to ensure its provision under certain frequency, price, quality or universality conditions. Until 14th March 2020,⁴ within the Canary and Balearic archipelagos, 16 inter-island routes, and one more between Menorca and Madrid (during the winter), were subject to PSOs. They include obligations regarding frequency, timetables, capacity and reference fares for the companies operating there.

¹ Measure regulated by Royal Decree 1316/2001, of 30 November, regulating discounts on fares for scheduled air and maritime transport services for residents of the Autonomous Communities of the Canary Islands and the Balearic Islands and the Cities of Ceuta and Melilla, and by the thirteenth additional provision of the Act 17/2012, of 27 December, on General State Budgets for the year 2013.

² The fare for the scheduled service is the price paid by passengers for their transport and luggage, including but not limited to applicable taxes and fees, except for the infrastructure usage fee and safety fee.

³ Regulated in Spain by Act 2/2011, of 4 March, the Sustainable Economy Act.

⁴ This date marked the passing of Royal Decree 463/2020, of 14 March, declaring the state of emergency for the management of the health crisis caused by COVID-19.

The design of aid available for air transport in the extra-peninsular territories has changed over the years. Thus, the percentage discount on the ticket price enjoyed by residents has gradually increased: from the 1980s to 2016, it represented between 10% and 50% of the fare; in July 2017, it was increased to 75% for inter-island journeys; and in July 2018, it was increased to 75% for journeys to/from the rest of the country.

Following this last increase in the discount percentage, the CNMC received requests from the DGAC and the Government of the Balearic Islands urging it to study price behaviour, competition in island passenger air transport markets, and the possible impact of changes in the subsidy system on these, questions which this study seeks to answer. Therefore, this study focuses on air passenger transport between the peninsula and island territories, as well as inter-island routes.

The CNMC has carried out a theoretical and empirical analysis of the design of air connectivity support systems for island territories, focusing on airfare discounts. To this end, the CNMC has held meetings with DGAC, the Independent Authority for Fiscal Responsibility (AIRef) and experts from academia.

It should be noted that the analysis carried out by the CNMC is based on data prior to the declaration of the state of emergency on 14th March 2020, in response to the health crisis caused by COVID-19. Therefore, the market situation following the declaration of the state of emergency and the measures taken are not analysed.

From the theoretical analysis of the different measures available to support island connectivity, it follows that these may produce a number of undesirable effects, beyond improving connectivity, which the competent authorities must take into account when designing and evaluating them. In the specific case of partial airline ticket discounts, demand from resident passengers is stimulated by reducing the final price they pay, which can lead to higher airfares, so that part of the aid to residents is transferred to airlines in the form of higher revenue. This partial transfer of the subsidy may take place, at least in the short term, even in a perfectly competitive environment. However, the rise in demand and fares increases the profitability of routes, which may encourage new operators to enter and, in the face of increased competition, the upward pressure on prices may be contained. The final effect will depend on the specific characteristics of demand and supply, as supported by the available empirical evidence, so that the impact may be different in each case.

As for the empirical analysis⁵ carried out by the CNMC, although direct causality cannot be established with the methodology applied, it is possible to see that, immediately after the last increases in the discount percentage, there were significant changes in the behaviour of some market variables.

Thus, on routes **between the islands** (both the Balearic Islands and the Canary Islands) **and the peninsula**, raising the discount to 75% in July 2018 was accompanied by a marked increase in the average price of tickets purchased by residents (before applying the discount) in relation to trends in the rest of the years between 2016 and 2019. This appears to indicate that, in the case of these routes, **a portion of the discount may have been transferred to prices**. This transfer may be motivated by the sharp increase in demand by residents and possible adaptation problems on the part of supply, at least at certain times of the day or week. In the case of non-resident travellers, the tickets purchased have not become as expensive as in the case of residents, as the former seem to have altered their consumption patterns to protect themselves from price rises, increasing how far in advance they buy tickets.

However, **this price increase is not seen in the case of inter-island routes**, where there is no significant discontinuity in fare trends starting in July 2017, when the discount was raised to 75%, despite the resulting significant increase in demand by resident travellers.

Different **supply factors can explain this difference in behaviour between routes**. Firstly, in the case of inter-island routes in the Canary Islands, just after the discount was increased to 75%, a new operator entered the market, which may have served to contain price increases. However, the operator announced its exit from the market in 2019, so the implications of the increased discount may change. Also, on inter-island routes, the **load factor** of flights has been lower than on island-peninsula routes, so airlines have had more room to absorb increases in demand. Secondly, at a good number of Spanish airports, there have been **congestion** problems for at least some periods of the day, week or season,⁶ and it is more common for island-peninsula routes to run between more congested airports than in the case of inter-island routes.

In any case, in the long term, airlines are more easily able to adapt their supply (over the last decade there has been a good adjustment of supply to variations in

⁵ The study of the different island routes was done using aggregates: Balearic Islands–Peninsula, Balearic Islands inter-island, Canary Islands–Peninsula, and Canary Islands inter-island.

⁶ IATA (2019).

demand), increasing flight frequency and number of seats, thus easing the pressure on prices.

Furthermore, demand from resident travellers has been driven up quite considerably in all groups of routes, and in no case is there a decrease in non-resident passengers' demand, so it can be concluded that after the increase in the discount percentage to 75%, **connectivity improved**. However, although there is no decrease in demand from non-resident travellers, there are changes in their consumption pattern, increasing how far in advance they buy tickets.

Finally, **the economic cost to the State doubled** in all route groups within one year of the percentage increasing to 75%, reaching 563.1 million euros in 2018. And it is expected to exceed 765 million euros in 2019 (while it had remained stable and even decreased between 2008 and 2016). In addition to the raise in the discount percentage, this sharp increase is a consequence of higher demand from residents in the case of inter-island routes, and also of higher airfares in the case of routes to and from the peninsula.

Given the price pressure the partial airfare discount appears to have generated on the island–peninsula routes, the CNMC proposes a series of recommendations to try to minimise it.

First, the indications of the transfer effect to prices as a result of the latest increase in the discount percentage, at least for the island–peninsula routes, should be cause for reflection by the authorities. It is advisable to **assess measures** to increase price sensitivity among residents (such as limits on the amount of the discount, more restrictions on the items that can be discounted, ex post settlement systems, or indicating the total ticket price to increase awareness of the total cost of the trip).

Secondly, it is necessary to **consider the entire support system** for island connectivity as a whole and to review it on an ongoing basis from the perspective of the principles of efficient economic regulation principles, in order to ensure that it is optimal. For example, certain aspects of the PSO scheme in force in the period under consideration impose restrictions that could be reconsidered, such as limitations on the load factor of flights or the method for setting reference fares, as they may lead to inefficiencies and discourage competition.

Finally, it is also advisable to **assess other possible aid mechanisms** to compensate for the isolation of residents on the Spanish archipelagos, such as a system of tax exemptions for residents, not linked to travelling.⁷

⁷ CNMC (2017).