6-2011

The Aircraft Sector Understanding: New Financing Rules that Reflect the Aviation World of Today

Daniel Friedenzohn
Embry-Riddle Aeronautical University, friedend@erau.edu

EXECUTIVE SUMMARY

As promised there is a special article in this issue and it deals with the contentious issue of export financing for commercial aircraft. I will readily admit to having a very limited understanding of the details of the international agreements that govern this activity, but Daniel Friedenzohn does and I encourage any of you wanting to explore the issue more fully to contact him at friedend@erau.edu. The article is a status report of where things stand today, but it is a story without an end. Very likely there will never be an end because, as the article makes clear, the several parties involved have widely different interests and agendas.

Since this issue is coming late due to the fact that fourth quarter data for the U.S. airlines was slow coming in, and it is time to develop the July market forecast, we will let Daniel's article stand in place of any more comments from us.

Edmund S. Greenslet
ESG Aviation Service

The Aircraft Sector Understanding: New Financing Rules that Reflect the Aviation World of Today

By Daniel Friedenzohn
Assistant Professor (LAW)
Embry-Riddle Aeronautical University

In late February, the Organisation for Economic Cooperation and Development (OECD) held a signing ceremony for the new Aircraft Sector Understanding (ASU) that governs export financing rules for aircraft manufactured in all OECD countries and Brazil. Unlike a treaty, which results in countries adopting a document with compulsory obligations, this accord is a "soft law" non-binding arrangement. And yet, this multilateral *gentlemen's agreement*, in its many versions, has been an effective tool in providing financing rules for civil and commercial aircraft. The ASU sets forth the most favorable terms that can be extended by export credit agencies to eligible parties acquiring aircraft.

The OECD is an organization whose membership is composed of 34 countries. Many of its members, such as the U.S. and Canada, are advanced economies. Some of its newest members, such as Turkey and Chile, are experiencing large economic expansion and growing aviation markets.

Many airlines such as fast-growing Emirates, Copa Airlines, and LAN have been able to take advantage of these favorable terms to acquire aircraft. The more established carriers in Europe and the U.S., however, have not been afforded these same terms. This is because three EU export credit agencies (ECAs) and the US ExIm Bank have agreed to a "*Home Country Rule*" which prohibits ECAs from providing assistance for the purchase of Airbus or Boeing aircraft to airlines located in France, Germany, Spain, United Kingdom, and the U.S.

Export credit rules for the civil aviation sector were first established in the 1980s. The OECD's Large Aircraft Sector Understanding (LASU) became part of a broader agreement called the Arrangement on Officially Supported Export Credits, which sets forth rules pertaining to export credits for various industries.

The LASU, however, did not cover regional aircraft, a growing and important part of the airline business. Accordingly, OECD members came to together in 2001 to start negotiating on a new agreement. The Aircraft Sector Understanding (ASU) went into effect in 2007 and covered Brazil and Canada, the respective home countries of Embraer and Bombardier. The ASU classified aircraft into three categories: (1) large commercial, (2) regional turboprops and jets, and (3) small aircraft such as helicopters and business aircraft.

(continued on page 4)

According to the OECD, export credit agencies (ECA) have generally provided financing for around 20% of aircraft deliveries. The ECAs became even more important during the financial crisis as they provided additional financing options for borrowers. In 2010, ECAs provided $20 billion in financing for commercial aircraft. The U.S. ExIm Bank stated in a 2010 report to Congress that between mid-2008 through the end of 2009, it supported a record $11 billion of aircraft transactions.

The U.S. government and its counterparts on the other side of the Atlantic have an interest in supporting their aircraft manufacturing business. According to an article by Martha C. White of Slate.com, Boeing generated closed to $29 billion in exports in 2009. This represented about 1.8% of all U.S. exports that year. This type of economic activity supports many U.S. jobs for Boeing and its suppliers.

The push for a new agreement has been building for several years. Bombardier's decision to build the new 100-149 seat C-Series airplane led Canada to classify it as a regional transport. The aircraft is a competitor to the Airbus A320 and Boeing 737 family of airplanes. The EU and the U.S. argued that by allowing the C-Series to fall into the regional aircraft category, Bombardier would have an unfair advantage in the marketplace because the airplane would be subject to more favorable financing rules than either of its competitors. As a result, momentum started to build to amend or revise the ASU.

Another reason that U.S. and European policy makers sought changes in the agreement has to do with the changing landscape of the airline business. The markets within the U.S. and EU are in a rather mature stage of development and are heavily saturated with low-fare carrier competition. Much of the new service that U.S. legacy carriers have added over the past few years has been to new international markets. The U.S. Bureau of Transportation Statistics data reveals that U.S. carriers added 12% more capacity (as measured by ASMs) on international routes this past February than in the same period in 2010.

An article by Ted Reed of TheStreet.com last fall highlighted an example of the financing terms afforded certain international carriers versus certain U.S. carriers. According to Reed, Delta Air Lines and Emirates each acquired three Boeing 777s in 2009. Emirates' loan-to-value ratio was 50% whereas Delta's was 40%. Tim Clark, CEO of Emirates, told Reuters last fall that only 20% of his carrier's fleet receive export credit agency supported loans.

Over the past few years, Delta and Emirates have become bigger competitors in the international marketplace. Delta and its joint-venture partners Air France, Alitalia, and KLM, however, compete with Emirates to carry some of the same traffic from the U.S. to the Middle East and Asia.

In January 2010, the CEOs of nine European carriers including Air France, British Airways, and Lufthansa formed an organization called the Group of European Home Countries Airlines. The group sent a letter to the OECD stating that "a major distortion of competition is caused by the fact that this group is among the few airlines not enjoying access to export credit support."

Europeans airlines were not the only ones raising concern about this issue. In August, 2010, the Air Transport Association wrote U.S. Treasury Secretary Timothy Geitner to express concern that the (now former) ASU put "U.S. carriers at a competitive disadvantage and create[s] wholly artificial incentives for the acquisition of new aircraft, flooding the global market for passenger traffic with uneconomic capacity." The industry trade group claimed in the letter that subsidies given to non-U.S. or EU carriers have allowed them to acquire "11 percent more capacity than if they had to pay market rates."

Boeing, having to walk a delicate line on this issue, continued to stress the importance that the ExIm plays in helping to create additional export opportunities for U.S. companies. In a speech given last December, Boeing CEO Jim McNerney shared that the ExIm Bank returned about $135 million to the U.S. treasury in 2009. McNerney also stated that the Bank played a critical role during the financial crisis by implementing financing programs that helped ensure that the credit crisis would not impact the aviation manufacturing sector.

The new ASU framework addresses many of the concerns set forth by U.S and EU carriers by reducing the gap between ECA and commercial financing. The minimum premium rates paid by borrowers will increase under the new agreement. It eliminates the aircraft-type categories and provides a system of common rules for all equipment types. It also provides that parties who are from countries that have ratified the Cape Town Convention are eligible for additional discounts.

The effectiveness of the OECD's ability to get important aviation countries to agree to an export credit framework is evident in that no country has ever withdrawn from this type of agreement. But that may soon change. The Canadian government has apparently decided to offer loan guarantees for the Bombardier C-Series jets. In May, the Seattle Times reported that Chairman and President of the U.S. ExIm Bank Fred Hochberg told Boeing that the bank would provide loan guarantees to domestic carriers wishing to acquire 737s. This constitutes a violation of the Home Country Rule and could undermine the new ASU.

The new ASU reflects in part the changing nature of the commercial air transport sector. Airlines from Europe and the U.S. were successful in convincing negotiators to reduce the financing gap between ECA and commercial financing. The new agreement will benefit commercial lenders since the ECAs will no longer be able to offer the same type of financing terms that they did under earlier agreements. Aircraft manufacturers will still benefit from export opportunities financed in part by ECAs. Only time will tell how effective the ASU will be in meeting the expectations of airlines and aircraft manufacturers alike.

The OECD's work is certainly not complete. The organization is working to bring other important parties into the ASU framework. The organization has invited China and Russia to sign on to the agreement. Both countries have growing and important commercial aircraft sectors. Russia's Sukhoi delivered its first Superjet 100 in April. China's Comac 79-seat ARJ-21 is currently undergoing flight tests. Comac is also in the late stages of finalizing its C919 design. The 156-seat aircraft is intended to be a worthy competitor to both the Boeing 737 and Airbus A320 family of airplanes.