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DG Competition

Markets and cases IV — Basic industries, manufacturing and agriculture
State aid: industrial restructuring

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Permanent Representation of Italy
Rue du Marteau 9,
1000 Brussels

Subject: State aid SA.58173

Dear Sir/Madam,

I refer to the business plan of the NewCo ITA (“the Business Plan”) sent to the European Commission on 21 December 2020. As you know from preceding exchanges, the Commission needs to verify that the creation of the NewCo satisfies two main tests:

- First, the Commission needs to establish whether the NewCo is in economic discontinuity with Alitalia. This test is based on the criteria identified in the relevant precedents of the Court of Justice (“faisceau d’indices”). Those criteria consist in the market price, the identity of the shareholder(s) of the NewCo, the object of the sale (including the assets, staff and contracts retained by the NewCo), the economic logic of the transaction and the time when the transfer takes place. Questions under chapter A below are aimed at obtaining the relevant information in this regard.
- Second, the investment planned into the NewCo needs to be market-conform. In other words, a private investor operating in the normal conditions of a market economy should have made the investment in question (the so-called “MEOP test”). Questions under chapter B below are aimed at gathering the necessary information to verify that the investment of the Italian State in the NewCo fulfils the MEOP test.

A. Economic Discontinuity

As discussed on several occasions in the past, the case team believes that the following would help to ensure discontinuity in this case:

- To ensure a market price, assets should in principle be sold by means of an open, transparent, non-discriminatory and unconditional tender;
- The NewCo should not retain the combined aviation, ground handling and maintenance businesses. It should focus on the aviation business. The ground handling and maintenance businesses should be sold separately to a third party;
- A number of slots at congested airports should be given up;

- The Alitalia brand should not be retained by the NewCo, since it is an emblematic indicator of continuity. Alitalia's loyalty programme should not be simply transferred to the NewCo. Also in this case, a tender is the preferred manner to ensure discontinuity.

In light of the foregoing, please answer the following questions:

1. Market price

We understand that the acquisition of Alitalia's assets by the NewCo will not be the result of an open and transparent tender. Please indicate the detailed reason(s) of this choice.

2. Identity of the shareholders

Please explain the shareholders' structure of ITA, its evolution throughout the 2020-2025 period and compare it with Alitalia's shareholder structure over the 2015-2020 period. Please explain whether a different shareholding structure was envisaged for ITA and whether a private placement was also envisaged.

3. Object of the sale

i. NewCo's routes, comparison with Alitalia's routes

According to the draft Business Plan (slides 28 to 31) ITA's strategy would be: focusing on core long-haul markets, maintaining the overall capacity while rationalising unprofitable domestic routes and expanding on selected premium European markets. In light of the foregoing, please answer the following questions:

- A. How will ITA organize its strategy of focusing on routes with a positive contribution to the network? How will it identify the routes in question, in particular domestic, where there is a strong competition with low-cost carriers? Did ITA carry out a preliminary market analysis of competition on domestic routes?
- B. Please explain how this strategy differs from the normal season to season route selection that Alitalia was performing between 2015 and 2020.
- C. Please indicate in detail which are the long-haul routes on which ITA will focus its operations and which are the long-haul routes already covered by Alitalia which ITA will not take up. Please indicate which are the key strategic routes to be launched in 2021. Please also justify the sources, calculations and anticipations of the demand for long-haul flights, on which ITA will base its industrial strategy.
- D. Please provide an (Excel) route by route profitability analysis which indicates all the routes that Alitalia served in the period 2015-2020 (by years) with information on passengers, number of flights, variable costs, fixed costs and overall profitability. Please also provide your estimates on the expected profitability of each route for ITA (on the same disaggregated basis) and reconcile the profitability of Alitalia in the period 2015-2020 and the expected profitability of ITA for 2021-2025.

- E. Please indicate in detail which are the domestic and European routes, already covered by Alitalia in 2015-2020, which are not going to be covered by ITA's operations and the reasons for these choices (profitability, strategy, etc.). Please explain in detail the reasons why, according to the draft Business Plan (slide 31), a partnership with a European player from 2022 is crucial for ITA's growth in the medium haul European market. Please also justify the sources, calculations and anticipations of the demand for domestic and European flights, on which ITA will base its industrial strategy.
- F. Please provide evidence from internal documents of Alitalia on what would be the expected routes that it would be operating in 2021.

ii. ITA's transport capacity

As mentioned above, one of the parameters to assess lack of economic continuity is that of a reduced perimeter of operations by comparison to Alitalia. As an indicator, the transport capacity of the present Alitalia was reduced to 69% (in terms of passengers/ km) of the old Alitalia in the 2008 Alitalia discontinuity decision.

- A. In this regard, please indicate in detail if and how a comparable reduction of transport capacity will be achieved between Alitalia and ITA, making specific reference to ITA's forecasts of transport capacity from 2021 to 2025 as described in the draft Business Plan. Please explain in detail how ITA will achieve the planned growth, focusing on how the relevant factors of production (workforce, slots, airplanes, etc.) not taken up in 2021 will be acquired.
- B. Please provide internal documents of Alitalia which indicate the level of activity the company was expected to achieve in 2021 and 2022 without new capital injections. Please contrast these estimates with ITA's forecasts.
- C. We understand from the draft Business Plan (slide 41), that part of the old Alitalia fleet will be leased to ITA. Please provide details and justification of the price of the lease agreements and why this would be a market price (the draft Business Plan mentions "best market conditions"). Please indicate whether and for how many aircrafts will ITA replace Alitalia in existing lease agreements with third-party providers. In all cases, please describe the conditions applied to the leases. In case of renegotiation of leases, please explain to what extent such renegotiation took place in anticipation of starting of operations by ITA or as part of the normal business of Alitalia, similar to other airlines in the current COVID context.
- D. Has ITA already entered into discussions with aircraft manufacturers on the pricing of new aircrafts? How does this pricing and terms compare to what other companies have been able to secure?

iii. ITA's hubs strategy and surrender of slots at congested hubs

- A. We understand that Alitalia has accumulated consistent losses and steadily lost market shares, in particular because of the exploitation of three competing hubs (Fiumicino and Malpensa for long-haul, Linate for short/medium haul). We also understand from the draft Business Plan that ITA's strategy is to maintain a multi-hub strategy keeping its hubs in Fiumicino and Linate (using the second one mainly for intra-European traffic). Please explain in detail the rationale underlying this strategy, providing any supporting evidence of its discontinuity with

the previous multi-hub approach by making reference to the traffic and the proportion of the revenues generated in each of the three airports in 2015-2020 in the case of Alitalia and the projections for ITA for the period 2021-2025.

- B. As mentioned above, one of the indicators of economic discontinuity is the surrender of a meaningful number of slots at congested airports. The draft Business Plan indicates maintaining control over Linate and Fiumicino's slots as one of the central elements of ITA's overall strategy. More in general, the draft Business Plan does not indicate whether and to what extent ITA intends to give up slots at congested airports. In light of the foregoing, please answer the following questions:
- For each of the two airports of Rome Fiumicino and Milan Linate, and for each of the summer 2019 IATA Season and winter 2019/2020 IATA Season, please provide a table including:
 - o the total number of slots requested by all carriers by the Initial Submission Deadline as set in the IATA Calendar of Coordination Activities;
 - o the total number of slots allocated to all carriers and the total number of slots available ;
 - o a list of all carriers having requested slots and, for each of these carriers, please provide:
 - the total number of slots requested by the initial submission deadline, and
 - the total number of slots allocated to the carrier.
 - What are Alitalia's slots that ITA will not use at the start of its operations in 2021? Please indicate how many of the mentioned slots are situated at congested hubs (e.g. Charles de Gaulle, Heathrow, Frankfurt, Madrid Barajas, etc.). Please also indicate how many among the mentioned slots will be given up and how many will be put on hold in view of their usage at a later stage.
 - How many of Alitalia's slots at Linate and Fiumicino will be taken up by ITA in 2021 and how many will be subsequently taken up between 2021 and 2025? Please explain what will be the status of the slots not used at the start of operations in 2021 in these two airports.
 - Please explain the degree of congestion in Linate and Fiumicino.

iv. ITA's staff

- A. We understand from the draft Business Plan that ITA will start in 2021 with 5 200 – 5 500 FTEs. We understand that this staff comes from the current Alitalia. Please confirm. Please explain on which basis, under which type of agreement and at which conditions will Alitalia's staff taken up by ITA in 2021 be hired. Please explain in particular whether ITA will take over existing staff contracts and at what conditions. Please also indicate what will happen to Alitalia's employees that will not be taken up by ITA in 2021, specifying in particular whether they will be made redundant or not. Please also provide information on the number of Alitalia staff that effectively worked in the period after March 2020 on a per month basis.
- B. We understand from slide 51 of the draft Business Plan that the number of ITA employees will reach levels comparable to those of Alitalia already in 2023 (8700/9100 employees). Please indicate on the basis of what elements and what processes the decision to increase the workforce will be taken. Please provide a detailed description of the selection processes specifying whether and under which conditions ITA will have any contractual or legal

obligations to hire preferentially ex Alitalia employees. Please indicate what will be the contractual and economic conditions applied to new hires and whether and to what extent they will differ from those applied to former Alitalia employees taken up in 2021.

- C. Please provide a detailed description of how ITA's staff will be distributed among the different activities planned (aviation, ground handling, maintenance). Please also indicate what are the contractual and/or economic conditions applied to each category of employees (types of contracts, flexibility in hiring and dismissing).
- D. Staff productivity: At slide 42 of the draft Business Plan you indicate that in 2025 ITA's CASK will be lower than that of FSCs in 2019 and slightly higher than that of LCCs (always in 2019). Can you please explain how the CASK of FSCs is expected to develop until 2025? At slides 50 and 51, you envisage a productivity alignment to market benchmarks (750 BH / year) through planning levers. Nevertheless slide 50 shows that the "target" productivity will be 6/7% lower than that of other FSCs, the main gap regarding pilots and captains employed for long haul flights. Are these benchmark levels based on 2019, 2025, or other figures?
- E. In light of the foregoing, please explain in detail what are the elements and the variables on which the achievement of the "target" productivity will depend. Please also explain why the "target" productivity is not in line or better than that of other FSCs. Please provide values for the envisaged productivity on a YoY basis from 2021 to 2025 and a comparison with the productivity levels of Alitalia in 2019 and 2020.

v. *ITA's perimeter of activities*

- A. As mentioned above, in order to guarantee economic discontinuity with Alitalia, it is important that ITA's perimeter of activities is different from that of Alitalia. Discontinuity would be easier to find, should ITA focus on the aviation business while giving up the ground handling and maintenance businesses. In light of the foregoing, please confirm whether ITA intends to maintain ground handling and/or maintenance within its perimeter of activities. Please also indicate what the strategic and economic rationale of this decision would be.
- B. As regards ground handling, we understand from the draft Business Plan that ITA intends to insource both above the wing and below the wing activities at Fiumicino airport while outsourcing at all other stations. Please confirm that this is the case. Please explain whether handling at Linate will be managed as in all other outstations. Please explain the reason for applying this approach and not a different one (e.g. Lufthansa's, which outsources below the wing activities). Please provide up-to-date indicators of the viability of the handling business for ITA, including detailed benchmarks with the main FSCs and LCCs. Please explain, in light of these elements, the rationale of maintaining handling within ITA's perimeter of activities at Fiumicino airport while outsourcing it in other airports. Please explain whether the ground handling activities are only for ITA (captive sales) or whether ground handling services will be offered to competing airlines. Please explain what are the complementarities that are expected to materialise if ground handling activities are to be maintained in Fiumicino airport.
- C. As regards maintenance, we understand from the draft Business Plan (slide 47), that ITA envisages to entrust maintenance to an ad-hoc created company fully controlled by ITA. This company will provide ITA with maintenance services at market prices. Please indicate the economic and strategic rationale for not acquiring maintenance services on the market from third-party providers.
- D. Please explain the complementarities, which are expected to materialise if maintenance activities are to be maintained.

E. Please provide separate financial statements regarding Alitalia's aviation, hub-handling and hub-maintenance activities in 2015-2020. Please also provide an estimate of the same statements for ITA's operations from 2021 to 2025.

F. Please specify the capital that would be allocated to each of the activities for ITA.

vi. Brand

Please provide an estimate of the value of the brand of Alitalia and provide support for this valuation. Please also explain whether ITA plans to acquire the brand at market price, and whether that market price would result from a tender.

vii. Other Alitalia's assets and liabilities

More in general, the draft Business Plan does not mention which assets and liabilities would be acquired by ITA from Alitalia. Please provide a detailed list of all the assets and liabilities that are taken over from Alitalia and explain how large those assets and liabilities are compared to the total balance sheet of Alitalia. Please also indicate the value those assets and liabilities and how it has been determined, i.e. whether they have been valued on a piecemeal or going concern basis as well as which valuation method has been used.

viii. Contracts

Paragraph 4ter of art.79 of the Decree-Law Rilancio provides that ITA will substitute Alitalia in the current existing public air services contracts concluded with the State in order to guarantee the territorial continuity. Does the objective of territorial continuity play a role in the creation of ITA? Please explain which PSOs will be ensured by ITA and whether tenders will be run to ensure the regularity of these PSOs.

ix. Loyalty programme

Please explain whether the old Alitalia loyalty programme will be discontinued and whether passengers will start accumulating only new miles.

4. Economic Logic of the transaction

Please explain in detail the economic logic of the transaction from the point of view of ITA's shareholder(s).

5. *Time of the transaction*

Please indicate precisely the moment at which the creation of ITA has been decided. Please also indicate the moment at which the transfer of assets from Alitalia to ITA has been decided and will be carried out. Please specify how the two mentioned moments can be positioned with regard to the ongoing Commission's procedures for illegal and incompatible State Aid regarding loans from Italy to Alitalia.¹

B. MEOP assessment

- A. The investment (equity injection) planned by Italy in ITA may raise State aid concerns as it is unclear whether it will be market conform. Please provide the Commission with an MEO or *pari passu* assessment on the basis of the draft Business Plan submitted.
- B. Please explain the economic rationale behind the decision to create a new airline company in the light of the current economic context affected by the coronavirus, which has particularly hit the aviation sector. Please explain how the existing uncertainty and risk are reflected in the draft Business Plan and the financial profitability of the project.
- C. Please provide details on the planned return on investment (ROI) for the Italian State in the capital structure envisaged in the draft Business Plan. Please provide adequate benchmarks and rationale demonstrating why the mentioned ROI would be acceptable for an investor operating under normal market conditions.
- D. Please clarify what would be the types of capital that the Italian State will provide to the newly established company separately for equity and for new debt (*e.g.* elaborate on what you provide in slide 87). In particular, for new debt, please explain the terms and characteristics of the debt instruments.
- E. Please explain the main assumptions underlying the data provided in slide 84, in particular the term loans and the revolving credit facility: please specify the terms of the debt funding and the estimated cost of the debt. You mention for example mortgage term loans. Why do you think mortgage term loans are the relevant comparator?
- F. Please explain what are the required rates of return for the new debt that underpin the MEO assessment. Please explain in terms of the characteristics of the instrument(s).
- G. Please explain what are the required rates of return for the equity injection that underpin the MEO assessment. Please explain in terms of the characteristics of the instrument(s).
- H. Please specify whether ITA will also secure financing from private sources. Please explain if concrete proposals have already been drafted by financial partners, which ones and at which conditions. Did the Italian authorities test the appetite of market operators for such financial operation?

¹ Cases SA48171 and SA55678.

Impact of economic discontinuity parameters on ITA's viability

We understand from the draft Business Plan and oral exchanges with the Italian authorities that ITA would like to maintain Alitalia's brand and loyalty programme as well as the hub-handling and hub-maintenance activities. We also understand that maintaining Alitalia's position at Linate's airport is key in the overall strategy underlying the draft Business Plan. As mentioned above all of these elements are of particular importance in the assessment of whether or not ITA will be in economic (dis)continuity with Alitalia. In light of the foregoing, please indicate:

- A. What percentage of Alitalia's slots at Linate, Fiumicino or other congested airports does ITA plan to give up without endangering the stability of its Business Plan? Please provide a detailed list of the slots.
- B. What would be the impact on the draft Business Plan of a decision not to be active in handling and maintenance?
- C. What would be the impact on the draft Business Plan stability of a decision not to acquire Alitalia's brand and loyalty programme?
- D. In case you indicate that any of the mentioned measures is likely to negatively impact ITA's draft business plan, please provide a detailed description of the underlying reasons. Please also explain the reasons why the mentioned impact cannot be avoided.

Financials and profitability

- A. Please provide projections of ITA's detailed balance sheet statement, profit and loss statement and cash flow statement for 2021-2025 in Excel format with visible formulas. Please provide the statements in a way that the financial statements are split by activity (ground handling and maintenance should therefore be visible separately).
- B. Please also provide longer-term estimates which would allow you to compute the net present value of the capital injection and provide justification for these longer term projections by making reference to benchmarks and market analyses.
- C. With regard to the profit and loss statement of ITA, please provide the revenue projections for 2021-2025 in Excel format and justify their level and growth rates based on underlying forecasts from market/industry reports (e.g. IATA) and/or peer companies.
- D. With regard to the balance sheet statement of ITA:
 - a. Please provide a breakdown of the projections of ITA's main asset categories, *i.e.* owned fleet, leased fleet, cash and liquidity, account receivables, inventories, deposits and all other items you deem relevant.
 - b. Please provide a breakdown of the projections of ITA's main liabilities categories, *i.e.* equity, financial debt, leasing liabilities, account payables, advance payments on tickets, provisions and all other items you deem relevant.
 - c. Please provide the capital plan (incl. equity issuance/repayment, debt issuance/repayment and capex) of ITA.

- d. Please explain ITA's capital structure at the launch of the company and its evolution on the 2021-2025 period.
- E. Please provide ITA's cost of equity (or cost of capital, if more appropriate) together with the details of the parameters for its calculation and their explanation. That explanation must include, *inter alia*, the sources of the risk-free rate (e.g. Italian government bond, 10-year maturity), equity risk premium and cost of debt, as well as the list of peers, together with their relevant parameters, that you used to calculate the beta coefficient.
- F. Please provide all the financial statements for the 2021-2025 period in the sensitivity scenario but also for the longer term estimates in an Excel format. Please also compute the net present value of the investment under the assumptions of the sensitivity scenario. Please explain all the assumptions that underlie the sensitivity scenario. Please also comment on the likelihood of such a scenario materialising.
- G. Please explain in particular what is intended at slide 88 under "Need to finance the funding gap through additional total equity injection up to c. €2.1bn, without considering any further potential disbursements for the purchase with cash or debt assumption of the assets and/or company branches of AZ in AS": what would be the impact of these further potential disbursements? Please explain also how these adverse scenarios are reflected as part of the MEO assessment.
- H. Slide 88: please explain whether you took into consideration the initial investment of EUR 20 million in the financial projections of the draft Business Plan and how (see footnote 1 in the slide).
- I. Does the sensitivity case mentioned at slide 88 correspond to the worst-case scenario mentioned at slides 80 and 81?

Yours sincerely,