

Commercial Viability

Being a geographical bridge between East and West, Europe and Asia, Ukraine has the evident task of become a central transportation hub between two continents. Several governments have set out strategic visions and long-term plans. However, efficient reforms start by revealing restrictions and constraints to investments. Big money, which the transport sector requires, usually follows sustainable commercial viability.

Ukraine's visa-free regime with the EU became the impetus for the aviation industry. **Dr. Anna Tsirat**, partner of **Jurvneservice Law Firm**, has revealed evidence of the sector's development. Some insights are definitely benchmarking for policy-making which is taken place at the moment.

UJBL During the last few years a number of air carriers (British Airways, Brussels Airlines, WizzAir) have scrapped flights to Ukraine. What is behind this? What obstacles do foreign airlines face in Ukraine?

Anna Tsirat: As both airlines (British Airways, Brussels Airlines) stated, suspension of flights to Kyiv was due to commercial viability. The threats to this viability were caused rather by their "own reasons" but not Ukrainian government policy aimed at attracting low cost airlines only, since British Airways scrapped its flights to St Petersburg too. As I know, WizzAir announced expansion of its flight program from Ukraine, with new flights planned from Odessa to Budapest, Berlin, Gdansk, Bratislava, Wroclaw and Katowice.

We expect foreign airlines to increase the number of flights to Ukraine as there is big potential of passenger flow from here. According to statistics only 5% of Ukrainians are active users of air carrier services. We believe this is due to the low incomes of Ukrainians. Thus, improvement in the economic situation in Ukraine and, correspondingly, an increase in the incomes of Ukrainians will enable them to travel by air more and so transporting from/to Ukraine will be of interest to both local and foreign carriers.

Foreign airlines come across the same problems as local airlines, namely slow and

expensive ground handling services provided by airports themselves or companies affiliated to them.

UJBL How favorable is Ukrainian legislation for foreign air carriers, especially low cost ones, for entering our market? Are our local airlines ready to compete with them?

A.T.: I would like to point out that Ukrainian legislation in the aviation field is undeveloped. Due to this and other factors Ukrainian companies are in a losing position in comparison with foreign airlines, including low cost ones.

First of all, let's start from the fuel issue. It is a well-known and very painful problem for Ukrainian carriers as the price of fuel forms the price of transportation and can form 26-41% of it. The airport infrastructure used for aircraft refueling services in Ukraine is outdated and requires significant investment in terms of refurbishment and modernization. The cost of maintaining fuel refueling complexes at Ukrainian airports in a proper technical condition, the imperfection of tax and customs policy make the cost of aviation fuel in Ukraine high compared to fuel in other countries. That is the reason why "fuel tourism" is thriving in the aviation industry. Ukrainian air companies that have international flights may benefit from

it but not those who operate only on the local market. I'd like to attract your attention to the fact that the fuel price is high irrespective of the 0% VAT rate that is applied to the supply of goods for refueling.

As soon as we mentioned the 0% VAT rate applied to refueling for aircraft operated on international routes, we need to stress that the 0% VAT rate is also applied to international avia transportation services and aircraft maintenance services for international flights. Services for operating aircraft that perform international flights are taxed at the 0% VAT rate too. These services include those that "are comprehensively necessary and directly related to the operation of an international flight, namely: servicing of aircraft and passengers at the airport (landing and taking off of aircraft, passenger service at airport terminal, ensuring aviation security, over-parking of aircraft); ground handling services for aircraft and passengers at airports; leasing of airport premises in the use of international flights (offices, check-in counters and other office premises rented by air carriers operating international flights); services of aircraft maintenance personnel" (I cited the current wording of Article 195.1.2 of the *Tax Code*). As we see, current tax legislation has created incentives for international transportation but not for local transportation.

KEY FACTS

JURVNESHSERVICE

Year of establishment: 1987

Location: Kyiv, Ukraine

Number of partners/lawyers: 5/10

CORE PRACTICE AREAS

Aircraft Finance
International Arbitration
Litigation
Foreign Awards and Judgments'
Enforcement
Franchising
Expert legal opinions
Corporate Law
Criminal Law and White-collar Crime



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That's why the cost of tickets for flying internally in the country is so high compared with international routes. That was the reason why the Aviation Committee at the Ukrainian Chamber of Commerce and Industry launched an initiative to equate international and local air transportation by rendering the same incentive to air transportation inside the country. In the event that the Ukrainian Parliament listens to it we'll be able to say that the tax issue has been resolved.

Equipment is another problem. Though Ukraine declares itself to be an aircraft producing country it, in fact, imports commercial aircraft. Article 105 of the *Customs Code of Ukraine* allows for Ukrainian airlines to import commercial aircraft under a temporary regime, i.e. without the payment of VAT, under operative lease agreements. This incentive will be limited from 1 January 2021, if unchanged, for aircraft which more than 30,000 kg and have a maximum capacity of more than 110 seats. Such limitation was introduced due to the Law of Ukraine

On the Development of the Aircraft Industry, No. 1796-VIII as of 20 December 2016 to support the domestic aircraft industry. In simple terms, aircraft that can be used for internal flights will be subject to a 20% VAT rate on importation. That will raise the price of local transportation even further.

An aircraft is a very complicated vehicle, whose parts, including engines, need to be substituted from time to time but if imported separately from aircraft may not be liable to a temporary regime. That is their import supposes the payment of VAT.

Due to the issue stated above and other issues that Ukrainian companies need to solve every day through different bureaucratic barriers Ukrainian airlines are, in fact, uncompetitive.

UJBL What is the situation with the fleets of our air carriers?

A.T.: Of course, any Ukrainian airline wants to renew its fleet but only some airlines like UIA, SkyUp, WindRose can afford that. The younger the aircraft — the higher the lease

payments. Lease payments are higher for Ukrainian airlines due to political risks and improper implementation of the *Cape Town Convention* in Ukraine.

UJBL We know that you have substantial experience of rendering legal support for aviation finance transactions. What are the core issues for foreign lessors in Ukraine?

A.T.: The most vivid problem for a foreign lessor who plans to lease its aircraft to a Ukrainian airline is the lack of understanding that aviation legislation is undeveloped and that there is no mechanism to repossess the aircraft quickly in the event of the lessee defaulting. One may object to my view, since Ukraine has been a party to the *Cape Town Convention* (CTC) since 2012, which provides for such mechanisms. In reality CTC is not implemented properly and if a foreign lessor wants to repossess the aircraft it may quickly de-register the aircraft but will definitely have problems getting access to it and its export from Ukraine. According to the World Aircraft Repossession index¹ issued annually, Ukraine has a very low ranking (only 45%), which reflects the problems experienced by foreign lessors here.

UJBL Could you be more specific on the banking regulatory issues that foreign lessors have to deal with?

A.T.: As you know, an aircraft is an asset. Any asset is used to attract funding under it. In the 1980s international financial markets proposed new schemes of financing to its participants to replace traditional lending. I'm talking about asset securitization that was first used in the United States, later in Europe and now all over the world. It supposes that an asset (in our case an aircraft or usually portfolio of aircraft) is set off the balance of a company (originator) and sold to a special purpose vehicle (SPV) usually set up in an off-shore jurisdiction. A parent to SPV issues securities, notes and/or equity participating certificates that are secured with the asset. The securities are sold on stock exchange to investors that receive their income for the account of lease payments generated by aircraft leases. This technique offers banks and non-financial institutions new and interesting ways to improve their ratios of liquidity and capital adequacy as well as risk management and balance structure. Though the National

¹ <https://www.pillsburylaw.com/images/content/1/2/v3/120554/BOOK-World-Aircraft-Repossession-Index-Third-Edition.pdf>

Bank of Ukraine provided for implementation of this technique as to problem assets of financial institutions in 2015, Ukrainian banks are not in general acquainted with this concept. As a consequence, a foreign lessor that uses its aircraft in a securitization scheme is treated by Ukrainian banks as a rogue company that carries out money laundering as under the Law of Ukraine *On the Prevention and Counteraction to the Legalization (Laundering) of Proceeds of Crime, the Financing of Terrorism and the Financing of the Proliferation of Weapons of Mass Destruction* and appropriate regulations of the National Bank a Ukrainian bank shall perform the “know your client” procedure before transferring any funds. In practice the performance of this procedure can take up to 2 months as a foreign lessor needs to submit a lot of different documents to disclose the essence of securitization transactions. All of these documents should be translated into Ukrainian and some of them even apostilled. Translation and apostillation takes a lot of time. Foreign lessors are ready to disclose the essence of the transaction in advance, prior to execution of special agreements, but Ukrainian banks do not want to work with drafts but only with executed documents. It's a vicious circle.

UJBL What is the purpose of the Cape Town Convention? Do you see pitfalls in its implementation in Ukraine?

A.T.: CTC was adopted as a special instrument that eases the mechanisms of aircraft financing and, in such a way, contributed to making the purchase or lease of an aircraft cheaper. It is important for countries that do not produce the aircraft as it allows their airlines to receive the aircraft for a cheaper price. Aircraft financing is cheaper if a creditor (either seller or financing institution or lessor) is sure that in the event of the failure of a purchaser or lessee it can repossess the aircraft within a couple of days, as an aircraft needs everyday technical maintenance. A stoppage in such maintenance for more than 7 days makes it extremely expensive to return the aircraft to operational status. It is due to this that CTC provides for speedy remedies for creditors that include speed repossession, even through a quick court order.

The Ukrainian court system is so clumsy and judges “are frightened” of foreigners so much that it's impossible in practice to receive a physical repossession order in a couple of days. De-registration of an aircraft is made at SAS but export through customs



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authorities that have no special regulation enabling a foreign lessor to export an aircraft.

CTC is an international treaty and state bodies, including the State Aviation Service and Customs Committee, should introduce appropriate regulations. The non-governmental organization Aviation Working Group proposes appropriate guides to ease the process.

UJBL What changes do you observe in the field of railway transportation?

A.T.: The liberalization of the rail transport market has led to a rise in the number of private freight wagons. In 2017-2019 alone, the fleet of private owners' wagons rose from 55,500 to 78,300, or 41%. At the same time, the working fleet of rail operator Ukrzaliznytsya (UZ) fell from 61,500 to 57,700 units of rolling stock, or 6%. Though UZ declared its intention to service private rail transport operators through the building of new wagons it underlined the necessity to develop special financial mechanisms that will facilitate those private operators

to purchase the wagons. We believe that the market has already developed them, though not in Ukraine. We are talking about securitization. The “financial problem” is accompanied with the so-called “competition problem”, as UZ, as a monopolist, gives priority to its own wagons or those leased through ProZorro, while private wagons are services that stand last in line. Adoption of the Draft Law *On Rail Transport* gives the green light to a “private thrust” that is not supported by some experts and UZ itself, as it may destroy it. Please pay attention that right now talk is about private transportation of goods but not persons. One expert pointed out that introduction of private thrust will cancel the main source of UZ income, which subsidizes passenger transportation, including suburban transport.

UJBL Do you anticipate the launch of a competitive market for railway transportation?

A.T.: I think that launch of “goods private thrust” is undisputable now. It is dictated



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both by the level of service provided by UZ and the market. Goods private thrust will contribute to passengers' private thrust as, in fact, The National Transport Strategy of Ukraine up to 2030 provides for "completion of structural reform of UZ, in particular introduction of a vertically-integrated management system with proper strategic planning of resources, as well as ensuring separation of the infrastructure operator from freight and passenger carriers". So, the issue has already been decided. We need to just understand the time of its implementation.

UJBL What do you anticipate in respect of the National Transport Strategy till 2030. How realistic, in your opinion, are the provisions?

A.T.: The Strategy was adopted a year ago. Its main objective is to create an integrat-

ed and securely functioning and efficient transport complex of Ukraine, to meet the needs of the population in transportation and to improve the conditions of doing business in order to ensure the competitiveness and efficiency of the national economy. This objective is ambiguous and quite realistic to my mind. The issue is the desire of all stakeholders to bring these tasks to economic life.

UJBL The government strategy on development of the aviation industry in Ukraine was recently published on official state sources. How realistic is it, from your perspective?

A.T.: Addressing this issue, I would remind you of the history of the government proposal as to development of the aviation field in Ukraine. Simultaneously with the

draft of the National Transport Strategy, the government issued the draft of the Aviation Transport Strategy in March 2018 (the Aviation Strategy). It was carefully discussed or, I would say, criticized, by participants in the field. According to the Aviation Strategy the rise in accessibility of air transportation for the population had to be done in the main for foreign low-cost companies actively invited to Ukraine.

The new government issued a draft of its program of development of all sectors of the Ukrainian economy, having formulated certain purposes for each sector. The aviation sector has the following aims:

- Approximation of the average ticket price to the European average;
- Passenger traffic growth by 60% (from 20 million to 32 million a year);
- Increase in freight flow by 20% (from 94,000 tons to 112,000 tons per year);
- Increase in the air mobility of the population (from 5% to 15%).

Their achievement is briefly described in 5 short paragraphs. I'd like to cite two of them — "We will provide citizens and businesses with convenient, accessible and safe air transport services, with the aim of supporting the modernization of regional airports, the introduction of new domestic and international flights, and facilitating access to the ground handling services market. Much attention will be paid to the development of low-cost aviation (increasing the proportion of low-cost aviation routes from 38% to 63%).

Market development should lead to new players, which will increase supply and reduce ticket prices. This will, in turn, attract new customers to this mode of transport, which will further develop the market."

To my mind this New Aviation Program does not differ from the old government Aviation Strategy, which assumed development of regional airports and attraction of foreign low-cost companies. These aims are good but I believe that we need national carriers to at least also use all those regional airports to whose development the government is allocating money from the state budget. The new minister has mentioned the necessity to treat international and local air transportation equally, which provides for cancellation of VAT on local routes. We will see whether this measure, if introduced, will be enough to breathe life into the local air transportation and to increase the number of national carriers.

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