

Aviation: an important catalyst for growth in the Saudi economy

by Pedro Castro - p.castro@tamimi.com - Riyadh

March 2018

The Saudi 2030 Vision is based upon growing inward investment to stimulate and diversify the economy and transform the Kingdom of Saudi Arabia into a global hub connecting Asia, Europe and Africa.

To support economic growth, the Saudi Government reaffirmed in December 2017 its investment plans for 2018 and announced that it will raise total spending to USD 293 billion. That investment is expected to generate revenue of USD 77 billion dollars in the 2018 Budget.

Aviation will play an essential role in the diversification and expansion of the Saudi economy. If we look to other countries in the GCC region, the UAE, especially Dubai, is a good example of how aviation can impact the development of the economy. The aviation sector currently accounts for 27% of Dubai's GDP and is expected to exceed 35% by 2020.

Aviation is set also to be an important catalyst in the development of the Saudi Arabian economy through the establishment of new airports and the expansion of existing facilities. The entry of new participants into the market will be an important development.

Market Overview

Forecasts anticipate significant growth in the number of air passengers worldwide and a significant hike in the global tourism industry. For example, the International Air Transport Association ("IATA") has estimated that passenger demand worldwide will double in 20 years, from 3.8 billion passengers in 2016 to 7.2 billion air travellers in 2035.

Airbus in its "Global Market Forecast 2017/2036 – Growing Horizons" and Boeing in its "Current Market Outlook 2017-2036" each forecast that airlines in the Middle East region will add substantial capacity to the market. Airbus estimates to deliver 2,530 aircraft to airlines in the Middle East in the next 20 years, whilst Boeing expects to make 3,350 deliveries. Other aircraft manufacturers also have high expectations for substantial growth in the Middle East markets.

This is being accompanied by strong investment in airport infrastructure. The investment is aimed at increasing capacity in both the commercial aviation and business jet markets, where manufacturers and operators are expecting very strong growth in the coming years.

The Kingdom of Saudi Arabia is matching these trends in the areas of airport infrastructure, airline investment and related businesses.

Infrastructure

There are currently 27 airports in the Kingdom, six are international, eight are regional and 13 are domestic. In order to improve the infrastructure of airport facilities, the Saudi Government has approved an expansion plan which contemplates both the upgrade of the existing airports and the construction of new airports.

The planned expansion includes the redevelopment of the airports in Abha, Al Ahsa, Al Qassim,

Arar, Hail and Jizan, new terminals at the King Khalid International Airport in Riyadh and the new King Abdulaziz International Airport in Jeddah. There are also plans to develop new airports in Al-Qunfudah, Farasan Island and Taif, Riyadh North (serving the provinces of Al Ghat, Al Majmaah and Zulfi) and Riyadh South (serving the provinces of Al Aflaj, Al Hariq, Al Kharj and Howtat Bani Tamim).

The General Authority of Civil Aviation of Saudi Arabia (“GACA”) has announced plans to privatize all 27 existing Saudi airports, as well as the new airports that are scheduled for completion by 2020. In 2017, the President of GACA, H.E. Abdulhakim bin Muhammad Al Tamimi, stated that the airports and relevant business units were to be transformed into separate companies fully-owned by Saudi Civil Aviation Holding Company (“SAVC”) with ownership to be transferred to the Saudi Government’s Public Investment Fund ahead of each company being privatized.

SAVC is a state-owned company established with the aim of improving efficiency and performance in the Aviation sector. SAVC’s mission is to make each airport an independent entity viable for privatization.

The process is underway with GACA envisaging three different models as exemplified by airport developments in Riyadh, Dammam, Jeddah and Medina.

In Riyadh, the King Khalid International Airport is being managed and operated by Riyadh Airports Company, which was established in 2016. And in Dammam, the King Fahd International Airport was transferred mid-last year to the new established Dammam Airports Company. Both companies are fully owned by SAVC. Minority stakes are to be sold to private investors.

In Jeddah, the operation and management of the new King Abdulaziz International Airport was awarded to a consortium under a revenue sharing arrangement with GACA bearing the costs in relation to the expansion project. However, very recently, on 21 February 2018, it was announced that GACA terminated the relevant concession agreement and it would initiate a new international tendering process soon.

In Medina, Prince Mohammed Bin Abdulaziz International Airport was developed on a build–operate–transfer basis, becoming the first airport in the Kingdom of Saudi Arabia built under a public-private partnership. The same structure is being used by GACA in the construction of other new airports, including Al Qassim, Hail, Taif and Yanbu.

The success of some of these projects may turn upon other investments to be made in adjacent areas in the years ahead and in some cases the reshaping of urban and industrial spaces that surround the airports. One good example is Taif, where the Saudi Government announced plans to create a new city comprising a technology hub as well as residential, industrial and educational areas next to the new airport’s location.

Airlines

Saudi Arabian Airlines (also known as Saudia) is the national carrier and main commercial airline in the country. With a fleet of almost 200 aircraft operating on 89 routes, including 62 international destinations across four continents, Saudia is the third largest airline in the Middle East. The airline has been renovating its fleet in recent years and has announced plans to increase the number of aircraft and routes by 2020.

The second largest airline in the Kingdom is Flynas, a low-cost carrier founded in 2007. The airline has a fleet of 31 aircraft flying to a total of 23 destinations in the region. It is also expanding. Last year, Flynas announced that it had reached an agreement with Airbus for a total of 80 new aircraft to be delivered between 2018 and 2026.

Other local airlines have started operations in recent years. Nesma Airlines has a total fleet of 10 aircraft and operates within the Kingdom of Saudi Arabia and between Saudi Arabia and Egypt.

SaudiGulf has a fleet of four aircraft and it has announced plans to expand internationally, including routes for the UAE and Pakistan. And Flyadeal, the low-cost subsidiary of Saudia which started operations in September 2017, has already announced that it expects to have a fleet of eight aircraft by mid-2018 and has plans for ordering 50 new aircraft in the near future.

While the majority of the aircraft worldwide is still owned by aircraft operators, there has been a significant boost in commercial aircraft leasing, particularly in the operating aircraft leases which increased from 22% of the global fleet in 1997 to 43% in 2017.

Industry terminology categorizes aircraft leases as either “dry” or “wet” leases. In a “dry” lease the lessor provides the lessee with the aircraft only, and it typically encompasses two types of arrangements, financial and operating. A financial lease is treated as a loan with the purpose of financing the acquisition of an aircraft. An operating lease is a renting-type arrangement which usually does not include an option to transfer ownership. In contrast to a “dry” lease, in a “wet” lease the lessor provides not only the aircraft but also the crew, maintenance and insurance under an “aircraft, complete crew, maintenance, and insurance” (or ACMI) agreement.

We expect local carriers to follow the market trend and opt for operating lease arrangements. This is because an operational lease gives flexibility to optimise the size of the fleet according to traffic growth. These lease arrangement also facilitate access to new aircraft. If airlines have short-term needs we could see “wet” lease arrangements as well. In any case, the projected fleet growth in the Kingdom will create new business opportunities for manufacturers, lenders and lessors.

Cape Town Convention: Limitations on its Application to Saudi Arabia

Foreign lenders and lessors need to be aware of the limitation on the application of the Cape Town Convention on International Interests in Mobile Equipment (“Cape Town Convention”) in Saudi Arabia.

At the time of ratification, the Saudi Government lodged a declaration under Article 54.2 of the Cape Town Convention stating that all remedies available to the creditor under any provision of the Convention shall be exercised only with leave of a Saudi court if there is no express provision requiring the submission of an application to the court.

Other than the above, the Saudi Government lodged no other declaration. In particular, no declarations were made under Article XXX of the Aviation Protocol to the Cape Town Convention. Hence, the provisions that require such separate declarations pursuant to Article XXX of the Aviation Protocol are not applicable in the Kingdom, including the following:

- Article VIII – Choice of law;
- Article X – Modification of provisions regarding relief pending final determination;
- Article XI – Remedies on insolvency;
- Article XII – Insolvency assistance; and
- Article XIII – De-registration and export request authorisation.

The limitations above should be taken into consideration by lenders and lessors when negotiating new lease arrangements with local carriers.

Related Businesses

The development of the aviation sector also relies on the development of navigation services, airport operation, manufacturers, aircraft maintenance services (known as “MRO” – maintenance, repair, overhaul, inspection or modification), ground handling (which includes cabin service, catering, fuelling and ramp services), logistics, and training. Charter flight carriers and business jets operators are also relevant to the market.

As part of the privatization program aimed at raising efficiency and achieving financial independence in the sector, GACA has also announced plans to privatize the recently established

Saudi Air Navigation Services Company (“SANS”). SANS provides air traffic control services and it is responsible for ensuring safe and efficient traffic flow in the Kingdom of Saudi Arabia. This requires close coordination with numerous entities such as military and adjacent air traffic control centres. Moreover, SANS is responsible for the provision, maintenance and operation of all air navigation systems such as communication, navigation and surveillance.

The renovated infrastructure and the growth in the Saudi airline industry will therefore lead to existing players expanding their businesses. It will also encourage the entry of new players into the Saudi market, especially in relation to MRO sector, ground handling services, logistics and business aviation to support the airport and airline expansion.

Regulatory

As in many other countries, aviation is highly regulated in the Kingdom of Saudi Arabia. The core piece of legislation is the Civil Aviation Law, enacted in 2005. This establishes a legal framework in Saudi Arabia in relation to:

- air transport and operations (including licensing);
- aerodromes and navigation service facilities;
- aircraft (including registration, rights, airworthiness and operation liabilities);
- airspace;
- flying permits and training;
- aviation accidents, search and rescue;
- crimes and acts against safety and security; and
- military aircraft.

The Civil Aviation Law applies to all aviation activities and operations in the Kingdom. Furthermore, it applies to all civil aircraft registered in the country, and to any aircraft registered in a foreign country and operated or maintained by a Saudi national or company by virtue of a lease or any similar agreement, if an agreement between the Kingdom and the aircraft registration country so states.

GACA Regulations regulate in detail all aviation matters related to:

- general provisions, procedural and administrative rules;
- airworthiness and aircraft maintenance;
- flight operations;
- airport and ground operators;
- air navigation services;
- licensing; and
- training.

GACA introduced new Regulations in 2016 but further changes could be made in the near future. As an example, GACA is in the process of amending Part 129 of GACA Regulations, which applies to foreign air carriers intending to operate commercial flights to, from, or within the Kingdom of Saudi Arabia. Until the amendment is finalised and enacted, GACA has implemented on 28 January 2018 an interim policy applicable to authorized foreign operators or foreign operators seeking authorization under part 129 of GACA Regulations. Under this interim policy, any foreign operator seeking authorization to operate within the Kingdom of Saudi Arabia must now be the holder of an air operator certificate for a minimum period of three consecutive years. The foreign operator must also have conducted the same type of operations and with the same type of aircraft within a 90 days period preceding the authorization date. In addition, authorized foreign operators will only be allowed to operate in the Kingdom under a “wet” lease from another foreign operator if the relevant lessor is also an authorized foreign operator. This interim policy aims to give more

protection to passengers, and it will remain in effect until Part 129 of GACA Regulations is amended.

Conclusion

The planned new infrastructure facilities and the airlines' expansion plans will create more employment in Saudi Arabia and generate business in ground services and other services along the supply chain.

The increase of the number of routes will also create further business opportunities in general, as it will encourage more foreign investment in the country. Finally, there will be an impact on tourism and leisure, especially taking into consideration the new projects and the new visa issuance procedures for visitors which are proposed.

It is clear that Vision 2030 heralds many opportunities in the aviation sector in Saudi Arabia for both established companies willing to expand their business and new players seeking to enter the Saudi market.

Al Tamimi & Company's Corporate Commercial team in Saudi Arabia regularly advises on transactions in the [Aviation sector](#). For further information, please contact Grahame Nelson (g.nelson@tamimi.com) or Pedro Castro (p.castro@tamimi.com).