Adrian Corcoran
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Commission for Aviation Regulation
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Dear Adrian,

Aer Lingus is pleased to respond to the Commission for Aviation Regulation's Methodological Consultation and Issues Paper (CP 1/2022) for the Third Interim Review of the 2019 Determination of airport charges at Dublin Airport. We welcome the CAR's decision to seek stakeholder views on how to tackle the challenges of the next review.

Our comments fall into two categories – some general feedback, and comments on specific matters. We deal first with the general comments.

General Comments – the impact of Covid
The impact of Covid on our industry is well documented and we do not repeat it here. Of more interest in this context, however, is the impact of Covid on the CAR's work. In essence, Covid is just another unanticipated demand shock albeit one which has been of longer duration and has had greater impact than previous market shocks. We already understand from previous experience that there will be adverse demand shocks (e.g. SARS, volcanic ash and so on) while their precise nature and extent of the impact will be unpredictable. As a result, these sorts of shocks are already built into the regulatory model, and in general further accommodations are not required.

In short, we do not believe that the CAR needs to change the way in which it accounts for them – the model accounts for shocks already.

In addition, the CAR has conducted two previous interim reviews that have dealt with the effects of Covid. Retrospectively at least, the effects of Covid on Dublin Airport have been dealt with and the focus of this review should be limited to Covid's impact on the CAR's forward look for the remainder of the regulatory period. Accordingly, the only Covid effects left to deal with are around the added uncertainty about the nature of demand in the remainder of the Determination period. In reality, this is likely to be focused on the speed of recovery of passenger demand, rather than anything else.
Therefore, we encourage the CAR to continue to deal with risk from shocks in the same way that it has in previous Determinations (either by allowing Dublin Airport to bear the risk

within the control period or with Interim Reviews where the CAR judges the effects to be too strong to bear unmitigated within the control period). Should the CAR wish to make any further accommodation for Covid, then we believe such an accommodation must satisfy the following conditions:

- any accommodation for Covid specific risk or uncertainty must be temporary, limited to issues around the speed of recovery and be shown to be manifestly in passengers' interests;
- if it is not temporary, then the CAR must show that the net benefit of such a change is clearly and unambiguously in passengers' interests;
- a full cost benefit analysis of any change must be published. For example, a proposal on volume risk sharing by CAR would include a commensurate reduction in WACC by x basis points or the overall charge by €y per passenger.

General Comments - Regulatory response to Covid and risk

The purpose of economic regulation is to prevent the abuse of market power, and typically regulators do this by presenting the regulated entity with an incentive structure that incentivises it to behave as if it was a competitive business. The CAR documents the support that it and the Irish Government gave to Dublin Airport at Dublin Airport over the period of the pandemic. Paragraphs 2.9-2.12 of the CAR's document show that the CAR's support alone as a result of the previous Interim Reviews amounted to some €220m over two years. This enabled the Dublin Airport, despite a very generous redundancy scheme, to book a minimal loss of €2.1m (2020) and a profit of €39m (2021) when measured by EBITDA. By way of comparison, Brussels airport posted a net loss of €261m for 2020-2021.

Rather than exposing Dublin Airport to market forces or to the harsh realities of Covid, it is clear that the CAR and the regulatory regime insulated the Dublin Airport from the worst effects of Covid and transferred over €200m from passengers to Dublin Airport. If the actions of the CAR during Covid show anything, it is that Dublin Airport is protected by a regulatory framework that prioritises the airport's financial performance over customers, whenever a shock hits. As such, it shows creditors and the Airport's 'shareholder' that Dublin airport is a very low risk investment.

We also note the CAR's stated approach to price regulation has been that Dublin Airport should bear both upside and downside volume risk within the control period. Whilst it is clear that Dublin Airport will reap the benefits of upside risk, it is not the case that it bears downside risk as some sort of charitable venture. It is effectively compensated to take downside risk. This is because the CAR will take account of downside risk when determining the WACC for Dublin Airport. So, Dublin Airport's true position is that it takes all the upside risk and is compensated insofar as it takes the downside risk. That being the case, claims for additional reward when downside risk materialises must be taken within

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the context of whether the materialisation of downside risk was greater than the risk it has been rewarded for taking within period via the WACC.

Covid and recovery

We believe that the aviation industry will recover quickly from Covid and we are already seeing signs that lead us to believe that there will be a strong recovery in traffic in 2022. However, the recovery is fragile and we believe that the CAR faces a key strategic choice in setting the price cap for the remainder of the regulatory period. It can aid the recovery and further the Government's stated national policy to grow the hub at Dublin by concluding that Dublin Airport has had ample time to become efficient and is relatively low risk, and by setting a price which encourages volume growth and investment by the airlines. Alternatively, it can continue to allow Dublin Airport to be inefficient, insulate it from the effects of Covid and the need to behave like a competitive business, and set a price cap that raises charges at Dublin Airport and risks choking off the recovery. We urge the CAR to make the right choice.

Specific Comments

Loss Recovery

In principle, if Dublin Airport reaps the benefits of excess profits from traffic within the regulatory period (as it did during the previous regulatory period) then it should also bear the downside risk. During Covid by virtue of the Interim Reviews, CAR changed this treatment by effectively transferring money from passengers to Dublin Airport, and transferring volume risk from Dublin Airport to airlines and their passengers. Unlike Dublin Airport, airlines and their passengers are not compensated for taking downside volume risk, and so the unexpected transfer of risk to airlines caused a further financial loss. Consequently, if there is loss recovery to be undertaken it should be on behalf of airlines and their passengers and not Dublin Airport.

We agree with the findings of the Thessaloniki Forum that airlines and their passengers should not be responsible for losses that arise from inefficiency on the part of the airport operator.

We also point out that loss recovery is context specific. Loss recovery for a commercial company is determined by the market and its shareholders' and creditors' attitude to risk. In a state owned business, the attitude to risk is different – Dublin Airport and the Irish Government will not permit a strategically important asset like Dublin airport to be closed down. Consequently, the attitude to loss recovery is different, and losses can be recovered more slowly, if at all.

We also note the vagueness of the comments on loss recovery that regulators should investigate 'whether the financial losses arising from a crisis will have an unacceptably negative impact on the financial sustainability of the airport'. In this context, it should be clarified what is meant by 'unacceptably negative impact', and what is the definition of losses. We note that Dublin Airport made a profit in 2021 (unlike most of the industry), and largely due to support from the CAR and Irish Government performed well relative to the industry as a whole.

When considering its decisions on loss recovery, we believe that the CAR should demonstrate that their decision is manifestly in the interests of passengers.

Statutory Objectives

The CAR's duties are likely to change with the passage of new legislation. We welcome the fact that the CAR's statutory objectives will include a focus on sustainability and we are supportive of action by the CAR to facilitate the delivery of the Government's target of a 51% reduction in emissions over the next 8 years.

However, the CAR should provide greater clarity in how it intends to meet its new statutory objectives, with specific reference to ensuring that Dublin Airport's proposed investment in environmental measures is targeted, efficient, proportionate and timely. If Dublin Airport chooses to go beyond the required 51% reduction, the associated costs should not be funded by airlines (who will also be required to make significant investments to reduce emissions) through increased airport charges.

There are regulatory models that enable the Government to give guidance to the regulator on the interpretation of its duties and Government priorities. For example, one model which the CAR could look at would be OFCOM's Statement of Strategic Priorities. We would be happy to discuss this model with the CAR, as we feel it balances regulatory certainty and independence with guidance on the interpretation and relative weight of the regulator's duties.

Traffic Forecasts

There is always an inherent uncertainty and error in any forecast, and this will be true in this forecast period. There is, however, potentially a difference between the period when the market is recovering from Covid, and the period when recovery is near complete and traditional market fundamentals reassert themselves.

We agree with the CAR that in the immediate future, traditional econometric models may not perform well. However, we also feel that when the market has returned to a more normal state that the CAR's model should continue to work as well as it has in previous years. Similarly, we see that whilst bottom up models tend to forecast accurately in the short term, further out they are more prone to error. We also understand that from the CAR's perspective, bottom up models may appear subjective and leave the CAR more exposed to appeal.

Consequently, we would suggest that the CAR adopts a pragmatic hybrid solution:

- Years 1+2 of forecast are bottom up – based on a synthesis of traffic forecasts for Dublin Airport. Airlines in particular are likely to have a good feel in the short run for bookings and movements;
- Years 3+4 – once we are past Covid recovery and markets operating as normal, normal relationships will reassert and CAR can return to its normal approach.

Allocation of Risk

Whilst we are open to further discussions on the concept of risk sharing, at present we see neither the need (for the reasons explained above), nor that it would be in passengers' interests. Consequently, we would need to be assured that any risk sharing mechanism would be in passengers' interests and was supported by a suitably robust business case which showed both the degree of risk transferred to passengers and the reward for taking such risk (in other words, if x% of say volume risk was transferred to passengers, this would result in a reduction in the WACC by y basis points). An evidence-based presentation is therefore needed to enable us to take a reasoned decision on whether accepting more risk is in our and passengers' interests.

In terms of the risk sharing options presented by the CAR, without fresh evidence to the contrary, we favour the status quo. If the CAR were to adopt a risk sharing mechanism, our view is that the best option would be some form of traffic risk share, where adjustments would be made at the end of the regulatory period rather than in period. We would need to very carefully study the precise mechanism proposed and be assured that passengers were well rewarded for the transfer of risk. In any case, given that any risk sharing is Covid related, it should be clear that any arrangement would be temporary, does not set a precedent, and would only continue if it were proved to be in passengers' interests.

In general, and unless the CAR can show otherwise, introducing risk sharing is an unnecessarily complex response to the issue of uncertainty in forecasting the building blocks due to Covid.

OPEX

We agree with the CAR's proposal that opex should be calculated via a bottom up methodology. This creates the most potential to deliver an efficient level of opex and provide proper scrutiny to Dublin Airport's operating costs. We make the following more detailed observations:

- In general, the CARs approach should be to establish an efficient baseline for Dublin Airport – the previous Steer report commissioned by the CAR found that Dublin Airport was not efficient and the following steps are therefore required:
    - Consider whether Dublin Airport's response to Covid was efficient, and whether it has accelerated the journey to efficiency;

    - establish the current efficient level of opex together with the gap between this and Dublin Airport's level of opex;
    - establish an efficient level of opex for each year including an efficiency frontier challenge;
- We have concerns over Dublin Airport's response to Covid (e.g. the severance scheme seems to us to have been overly generous compared similar schemes in the industry; a lack of information on the opex build up – what exactly are the staff going to do, what are their grades and pay rates, and what is the business case?);
- we would like to see data on Dublin Airport's grade structure and wages (including benefits and job size), so we can establish whether it has an efficient structure and pays an efficient market rate. CAR should conduct such an analysis. We are also interested in seeing data on pension scheme contributions, scheme design and security costs (including scheduling);
- it should be clarified why the smallest reduction in opex in response to Covid was in consultancy services. It seems to us that this would be a very flexible line item;
- in general, we do not believe that glidepaths to an efficient opex level are in passengers' interests. If Dublin Airport cannot run an efficient operation, it should not be for passengers to pick up the bill. However, we accept that where the shortfall in efficiency is large then a glidepath is a pragmatic solution. In terms of the slope of the glidepath, we would expect that Covid provided Dublin Airport with the opportunity to make a step change in its opex efficiency, and so if a glidepath is still required, it should have a steeper gradient than the previous glidepath;
- a pass-through scheme for costs beyond Dublin Airport's control is unnecessary and unfair.
- We would be interested in exploring with the CAR the potential merits of an opex rollover scheme whereby opex efficiencies above CAR's opex challenge could be retained by Dublin Airport for longer than the control period – say 50% for further 2 years into the next control – in other words something akin to the commercial revenue scheme

Commercial Revenue

The CAR's econometric approach appears to have worked relatively well in previous years, and in principle we would support continuing with this approach. However as per our comments on traffic forecasts we do not believe that this would be wholly appropriate in current circumstances.

Instead, we would propose a pragmatic approach – so for example taking spend per passenger and multiplying it through by forecast traffic volumes for the first two years of the control, and then using the econometric model for the final two years.

On rolling schemes, we are open in principle to their reintroduction, but it depends on the detail, and CAR would need to show that they work in our passengers' interests. In this regard, we would request that CAR provide evidence from previous control period, for example, that the rolling schemes incentivised additional commercial revenues.

Cost of Capital

We would like to see a full re-opening of the WACC for this review. In addition, we make the following observations:

- CAR need to take specific account of the generosity of the overall settlement – if, for example, there is ample scope to outperform, overall risk is lower and the WACC should also be lower especially with regard to the aiming up allowance;
- as noted above, the measures taken by the CAR and the Irish Government have protected Dublin Airport from the worst impacts of Covid. This demonstrates the extent to which Dublin Airport is protected from global events and is a less rather than a riskier investment;
- we see no adverse structural change in Dublin Airport relative risk profile. If anything, it has improved, and CAR already accounts for risk and shock
- CAR must explicitly show the impact on WACC of each of their proposed risk sharing mechanisms;
- Dublin Airport is responsible for its gearing and financial structure – if those decisions place additional costs on Dublin Airport, over and above those of a notionally efficient business, then those costs should be borne by Dublin Airport, not by our passengers;
- we would ask the CAR to look again at the notional gearing ratio – for example HAL is notionally geared by the UK CAA at 60%

Capital Investment

Whilst we will be making detailed comments on the size nature and detailed composition of the proposed CIP during the forthcoming consultation process, we would make a number of more general comments and observations. In terms of the proposed CIP we have three observations:

We are disappointed by the extreme nature of the 'buy now get benefits later' approach that Dublin Airport have taken, especially with respect to the South Apron Hub Infrastructure not scheduled to deliver until 2029/2030. Consequently:

a) the CAR should re-confirm its policy that it does not support pre-funding;
b) airlines should not be charged for capex that generates no or little value (e.g. the west apron underpass) in the current regulatory period;
c) the CAR should re-confirm its policy that for assets with prolonged build times, only assets in use can enter the RAB and therefore be remunerated.

Consistent with the CAR's statutory objective that it should further the interests of current and future users, passengers should only pay for capex that is both efficient and needed. Consequently, we believe that the Steer efficiency research offset (-7.4%) should be applied to all Dublin Airport capex programmes unless they can prove that the forecast spend is efficient. We are also interested in cost not just from a quantity surveyor perspective, but from an upstream perspective. In other words – are Dublin Airport properly incentivised to ensure that their designers and architects only deliver options that are the most cost-effective solutions?

In terms of risk sharing on capex, we are in principle, against any form of risk sharing under the current arrangements. One of the principles of risk management is that risk should be allocated to those best able to control and bear it. Under the current capex arrangements, airlines have no say in the management of capex programmes, and therefore it is unreasonable to ask airlines to bear a risk that they cannot control. For example, we are extremely disappointed with the Dublin Airport's failure to prepare and submit planning applications and progress projects in a timely and efficient manner.

Quality of Service

In general, we agree with the CARs approach as outlined. However, we would question the language and the principles behind the penalties and bonuses. We object to the payment of bonuses as airlines and their passengers pay Dublin Airport to deliver a particular level of service in order to be able to plan and deliver and their operation. If Dublin Airport deliver a level of service higher than that required, that is not a benefit for the airlines and is simply unnecessary. In short Dublin Airport should not earn a bonus for delivering something, airlines do not want or need.

In relation to penalties, while we recognise that repayments have an incentive effect to encourage Dublin Airport to delivers the service to an appropriate service level. However, repayments should not be viewed as punitive, but rather a refund of some of the money paid for a service that was not delivered.

We are available to discuss any aspect of this submission as required

Yours sincerely,

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