7th August 2009

DAA Response to CP3/2009
Maximum Level of Airport Charges at Dublin Airport
Draft Determination

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Executive Summary

The Commission has a statutory responsibility to ensure that Dublin Airport is developed to meet the requirements of current and prospective users in an economically efficient way and that DAA is able to operate and develop Dublin Airport in a sustainable and financially viable manner. In order to fulfil these objectives it is necessary that the Commission allows:

- An adequate return on existing assets employed in the operation of the airport that is sufficient to attract the necessary funds to maintain and develop infrastructure
- The recovery of efficiently incurred operating costs
- Sufficient levels of capital expenditure to ensure that the airport is appropriately developed to meet current and future users needs
- Realistic and achievable assumptions in relation to all elements of the price cap derivation

Financeability

The consequences of the Commission's policy of deferring remuneration for required investment combined with the impact of the recession on passenger traffic and propensity to spend means that DAA is facing significant losses in 2010. Regulation of airport charges continues to be one of the most fundamental determinants of the financial strength and viability of the DAA. While the pace of economic recovery will be a key factor, a recovery in DAA's financial position from 2010 onwards is inextricably linked with the regulatory price cap determination. The company's credit rating has already been revised downwards this year, and the ratings agency Standard and Poors has ascribed a negative outlook to the company. This implies an expectation of a further deterioration in the financial profile and a further ratings downgrade. At lower ratings levels, DAA faces significant risks in terms of its ability to raise additional funding and the implications for the cost of such funding.

These impacts would have been mitigated to a considerable extent had the Commission addressed the concerns of DAA in relation to increased financial and regulatory risk when, in 2007, the Commission chose to defer any pricing increase to the next determination, notwithstanding allowing for the majority of DAA's capital expenditure programme.

Against this background, it is critical that the final determination delivers on previous commitments regarding adequately remunerating investment and meets the reasonable expectations of stakeholders as regards the deferred decision on pricing increases. DAA notes the policy of the Commission in this regard, as explained in the interim determination in 2007:

"The Commission places considerable value in establishing and maintaining a reputation of regulatory certainty and clarity, while at the same time striving to satisfy its three main statutory objectives as circumstance evolve. It would not be in the interests of airport users or the DAA if there was a perception that the Commission was minded to overturn commitments to allow the DAA to recover costs that the Commission had previously indicated would be included in the RAB".

As the Commission's decision on pricing increases has been expressly deferred to this regulatory period, the final determination would lack credibility if it failed to adequately address the need for a price increase to remunerate DAA's allowed capital expenditure program and the Commission would also undermine regulatory certainty going forward. Indeed, DAA is surprised and disappointed that the draft determination fails to address this issue as, in the words of the Commission, it is not in the interests of airport users or the DAA that there is a perception that the Commission is minded to depart from its stated policy.

DAA acknowledges its role in meeting the short term earnings deficit and has initiated and is implementing a wide-ranging cost recovery programme. This will maintain Dublin's position as an extremely competitively priced airport. Current passenger charges at Dublin are among the lowest of any major European airport and have actually fallen by more than 30% in real terms over the past 20 years. The increase in airport charges necessary to pay for the essential new investments and maintain service quality at acceptable levels will still leave Dublin Airport extremely competitively priced, due to DAA's efficient operating expenditure and our track record in generating high levels of commercial revenue to subsidise airport charges.

Unfortunately, despite the gravity of the financial crisis facing the company, the Commission's draft determination is flawed in a number of significant respects:

- It proposes to apply a lower cost of capital than was implemented at the last review despite the impact that the economic crisis and volatility in financial markets is having on the cost of debt and equity
- It proposes challenging operating cost efficiency targets but does not allow the significant up-front costs required to achieve such efficiencies or recognise that the business, because of its ownership cannot make redundancies without agreement and because of its national strategic importance is limited in the actions which it can take to procure such an agreement
- It has adopted a short term view by disallowing capital expenditure that is required for the future development of airport infrastructure
- It has based conclusions on preliminary, incomplete and flawed assessments of individual building blocks and used these to inappropriately replace DAA's detailed analyses
- It incorporates commercial revenue targets that are overly ambitious in the current economic climate and has disallowed the investment required by DAA's plans as a precondition to their achievement
- It adopts traffic forecasts that are more optimistic than those put forward by either DAA or airline users and economic growth forecasts that are out of line with current expert views such as the IMF
- It proposes the creation of a costly, asymmetric and administratively complex system to address service quality, despite accepting that existing service levels are appropriate

In particular from the financeability perspective, the draft determination fails to:

- Deliver the pricing capacity that allows the minimum financial thresholds, adjudged by regulator, company, lenders and rating agencies as necessary, to be achieved throughout the period thereby providing those parties with sufficient clarity and evidence of real commitment to allowing DAA to achieve an appropriate credit rating
- Reflect the necessary level of regulatory support and commitment for a sufficiently strong investment grade credit rating or to provide the necessary comfort to lenders and, in fact, acknowledges that financial ratios may be sub-investment grade for at least part of the determination period
- Enable DAA to bridge the substantial and immediate shortfall in earnings due to the economic downturn
- Adequately remunerate the investment in T2 (leading to a deficit in excess of of c€250 million between the actual financing and depreciation costs incurred by DAA and the allowed revenue for T2 capital costs in the draft determination)
- Deliver an appropriate and/or effective return on investment thereby severely suppressing profitability and eliminating dividend capacity. DAA calculate that the draft determination results in an actual average return on the RAB for Dublin that is well below the cost of capital proposed by the Commission

- Sufficiently protect DAA's financial status, leaving the Group heavily geared with inadequate cashflow, notwithstanding the €0.5 billion injection of equity from the sales of Great Southern Hotels and ARI stakes in Birmingham and Hamburg Airports.

As a consequence, the Draft Determination in its current form is, in the opinion of the Board of DAA, highly likely to result in a credit rating downgrade into the BBB range, The Commission, on the other hand, has indicated that its proposals will deliver financial ratios that fulfil its statutory objective to enable DAA to operate Dublin Airport in a sustainable and financially viable manner and maintain investment grade, pointing to Table 10.1 of the Draft Determination which indicates an average FFO-Debt ratio of 16% over 2010-2014 and a ratio of 26% in 2014. However, the Commission's financial model has demonstrated that the ratio is below the ratings agencies' minimum threshold for investment grade at least some years in the price control period, even on the Commission's own projections, assumptions and methodologies. As is clear from the points made above, the assumptions incorporated in the building blocks that lead the Commission to its conclusion are at best overly optimistic and at worst completely disregard the risks and challenges in DAA's business environment with the highly likely result that they are undeliverable. Flaws in the Commission's financial model also mean that the ratios it has projected are incorrectly calculated and cannot in fact be realised. Furthermore, against a backdrop of current financial ratios of below 10%, investors are unlikely to take much comfort from signals by the Commission of higher ratios at the end of the regulatory period when the Commission indicated expected ratios of above 15% for 2009 in making its interim decision in 2007[1]. Indeed, investors have already indicated such lack of comfort to DAA on the basis of the Draft Determination.

In short, the application of the draft determination would result a significant deterioration in DAA's financial profile such that it could not generate the sustainable profits necessary to fund investment, replace and replenish existing debt maturities and maintain service levels. The Commission's own financial model illustrates that even with lower proposed capex and operating costs, DAA will need to raise an additional debt in 2011 at a time when its FFO: Debt ratio would be less than in such a scenario it is highly unlikely that existing lenders would be 'open' for DAA and the company would at best be dependent on the volatile and expensive bank market for funding. It is submitted that in any case, such bank markets are incapable of generating the longer maturities which are required to support long-term infrastructural investment.

It is imperative that the Commission revisits its assumptions and also adequately tests its outputs against all plausible substantial downside scenarios prior to making its final determination.

Finally, the Commission has continued to adopt a "building blocks approach" in arriving at its draft decision. DAA has many concerns about various aspects of the Commission's analysis, particularly the asymmetric approaches, simplistic and methodologically flawed analyses and unfair features that are apparent in some aspects of the proposals. These are set out in detail in the individual sections later in this document. For ease of reference we have summarised and tabulated the core concerns in Supporting Document I - Summary of Key Concerns re the Commission's Approach to the Building Blocks and urge the Commission to address them before it makes its final decision. It its critical, however, that in addition to addressing these issues on an individual basis that the Commission concern itself with the cumulative impact of these elements of the determination which give rise to the serious concerns for the financial sustainability of DAA highlighted above.

[1] CP6/2007 stated that *"the Commission is satisfied that the FFO:debt ratio should remain above 15% for the remainder of the current regulatory period even allowing for the proposed additional capital expenditure the DAA proposes to undertake before 2010."*

Introduction

This document is the Dublin Airport Authority's (DAA) response to the Commission for Aviation Regulation's (the Commission) request for submissions in relation to CP3/2009 - "Maximum Level of Airport Charges at Dublin Airport Draft Determination".

In replying to the Draft Determination, DAA requests that the Commission pay due regard to the company's previous formal submissions – its response to the Issues Paper dated 18th December 2008 and the suite of documentation provided as part of its Regulatory Proposition on 8th April 2009.

DAA would like to note that it has necessarily focused its response on what it believes are the key areas of importance in the Draft Determination. As a result, lack of commentary in respect of a particular point should not be interpreted as agreement with same.

This paper presents DAA's response to the broad proposals made by the Commission in CP3/2009.

Section 1 commences with a discussion of the financial impact of the Commission's proposals.

It is clear to DAA that the application of the Draft Determination would result a significant deterioration in the company's financial profile such that it could not generate the sustainable profits necessary to fund investment and maintain service levels. In the draft decision the Commission has created a situation where the regulated business would be incapable of generating the sustainable profits necessary to enable necessary investment in the business and maintenance of acceptable service levels. DAA is only in a position to continue trading through the current economic downturn as a result of the previous disposals of unregulated assets and prudent financial management in its funding strategy. Given DAA's legislative duty to remunerate its capital, this is not an acceptable outcome, and is certainly not in keeping with the Commissions statutory objectives.

The paper subsequently follows the order in which the issues were raised in CP3/2009. The key concerns in each of the sections are summarised as follows:

Service Quality Issues are addressed in Section 2

DAA interprets the Commission's decision to set quality of service targets at existing levels as an acknowledgement that current standards of service quality at Dublin Airport are appropriate. Against this background the Commission's proposal to institute a costly and administratively complex penalty system is unwarranted. Instead DAA's performance should be actively monitored and the results published. At a minimum, only the 'passenger-facing measures' should be formally linked to the price cap. The 'airline-facing' measures should not be linked to the penalty system, as there are a number of complex issues that need to be resolved in relation to them. If the Commission insists on including both elements of a scheme, then the penalties should be weighted to reflect the primacy of 'passenger facing' measures.

Section 3 deals with the Commission's approach to Traffic Forecasts

The Commission has adopted its own traffic forecast for the purposes of the draft determination. Its forecasting methodology recognises GDP as the primary driver of traffic, but this is applied in a considerably more simplistic manner than normal by using a global GDP elasticity figure of 1. The Commission should revert to use of DAA forecasts as in previous Determinations. Should it not do so, it should protect DAA from the volume risk

associated with its forecasts deviating from actual traffic in future. At a minimum, the GDP data used in the forecasts needs to be updated in line with current views of economic experts (e.g. IMF) on the rate of economic decline and potential for subsequent recovery.

Section 4 focuses on Operating Costs

The Commission's overall evaluation of the efficiency of DAA's operations at Dublin Airport stems from an incomplete and flawed assessment, which includes inappropriate use of benchmarking data to misrepresent the actual efficiency currently achieved by DAA.

The Commissions assumption regarding no real wage growth during the five year determination period is not viable. This assumption does not reflect:

- the reality of existing terms and conditions of much of DAA's work force
- the legal issues involved
- the required fundamental shift in the industrial relations climate and the potential cost of such shift
- the upfront cost that would be required to bring about the change implicit in the assumption.

The Commission should acknowledge the significant cost burden required to meet the FTE efficiencies proposed in the Draft Determination and should remunerate DAA for this cost on an upfront basis.

DAA welcomes the Commissions proposal to treat the T2 tender cost as a pass through in the price cap. It is also essential that all assessments for which the Commission will have full information are clarified in the final determination and not deferred pending the outcome of the T2 tender.

The Commission's approach to Commercial Revenues is reviewed in Section 5

The Commission's use of elasticities to forecast commercial revenues is simplistic and the results should not be substituted for DAA's detailed bottom up assessment. The Commission appears to take comfort from the fact that its outcomes are broadly aligned with the figures in DAA's April submission; however this ignores the following:

- DAA's forecasts included commercial capex to help retain existing business and generate the forecast growth in revenues - the Commission has largely disallowed this capex
- The macro-economy has worsened since DAA's forecasts were submitted and some of the downside risks we highlighted are now being realised

The Commission's assumption that T1x is generating only €3.8m p.a. is incorrect. The projected average income over 5 years is circa . The project over its lifetime generates a return in excess of the cost of capital allowed; therefore the Commission should avoid complexity and treat T1x in the same manner as other allowed capex.

Given that the current regulatory regime acts as a disincentive to investment in commercial projects, DAA would welcome the opportunity to discuss further the Commission's proposal to exclude car parking from the single till.

Capital Costs are the focus in Section 6

Regulated Asset Base – DAA welcomes the Commission's decision to set out the principles on which the RAB should be rolled forward in the future as this will give greater

regulatory certainty, however, important issues remain to be resolved. DAA is opposed to the Commission's approach to depreciation which is overly complex, and which exposes the airport to unnecessary and avoidable risks that are not associated with any discernible gain to user interests.

Significant reductions and omissions relating to the 2006-09 period have been made by the Commission in calculating the Opening RAB, including, inter alia,

- a significant element of the Pier D investment;
- capitalised project management costs
- claw-back of financing costs for T2 Box 2

These act as a disincentive to investment and should be amended.

Investment - DAA recognised the impact of the current economic downturn in submitting its capital investment proposals for the next five years and scaled back the level of investment previously envisaged by approximately 50%. DAA welcomes the fact that the Commission has accepted the principle of triggers for capacity projects so that projects can be initiated when growth returns.

Having taken a prudent approach to the proposed CIP and given that the Commission's consultants Booz/TPS found that "*DAA's capex unit costs match closely our independent cost analysis*", it is unreasonable that

- The Commission has only approved 50% of the tranche 1 and 2 projects (€198m out of €395m)
- The longer length runway has been discounted, contrary to the best interests of the wider economy and primarily on the basis of opposition from incumbent airlines who are anxious to protect their market positions.
- Almost all commercial capex has been disallowed, despite the fact that it represents a precondition to commercial revenue generation

In this response DAA reiterates the requirement and compelling evidence to support the inclusion of these projects as part of the Commission's final decision.

Cost of Capital - In its Draft Determination, the Commission proposes a real pre-tax cost of capital (WACC) of 7.0%, 0.4% lower than the cost of capital from the last price review in 2005. The proposed WACC is too low for several reasons:

- the financial crisis has led to an increase in the costs of both debt and equity capital across all financial markets. Against this background, investors would expect an increase in DAA's allowed cost of capital by comparison to the 2005 allowance, rather than a reduction;
- the lower WACC implies that the Commission believes DAA's risk has decreased since 2005, yet the changes to DAA's business and financial risks and regulatory framework are likely to have increased DAA's risk relative to the 2005 level;
- The Commission's proposals fail to take account of the Irish country risk premium which is a fundamental component of the market cost of capital. The recent downgrade of Ireland below AAA has increased the cost of capital for all Irish based entities by at least 1.5%;
- the cost of debt set by the Commission which draws on the cost of A rated bonds is inconsistent with the credit rating underlying the cost of capital.

If adopted, these proposals will adversely impact DAA's financeability therefore it is critical that the Commission reconsiders its proposals and increases the allowed cost of capital in its final decision.

Section 7 deals with Financeability
It is clear from the draft determination that the criteria set by Standard and Poors (S&P) for the maintenance of DAA's single A – rating, and potentially for any level of investment grade, will not be met. Therefore a downgrade to BBB range will be an inevitable consequence of the final determination unless it is substantially changed.

The paper concludes by dealing with Other Issues in Section 8
The Commission has proposed that any over-recovery on the price cap, including those resulting from a decrease in the cap due to service quality penalties, be refunded to airlines within 45 days of year end, though any under-recovery will not be repaid to DAA for two years, and is to be subject to an upper limit of just 5% of the cap. The Commission's approach is unnecessarily interventionist, biased against the regulated entity and has little appreciation or understanding of the practical consequences of its actions. DAA see no reason for changing the existing remuneration of under/over recoveries.

To supplement this paper, DAA has also provided a number of supporting documents which incorporate detailed assessments of specific elements of the Commission's proposals. Reference material related to some of the points made in various sections is provided in appendices.

DAA is available to discuss this submission in detail with the Commission and would welcome the opportunity to further explain the points made if this would assist the Commission to fully appreciate the views expressed herein. In addition DAA notes that the Indecon/Jacobs analysis of operating costs, has been acknowledged in the draft determination as "preliminary findings" and in the consultants own report as "emerging findings from our first-round examination". DAA would like to reiterate its willingness to engage further with the consultants with a view to assisting the next phase of their work.

Some material in this document has been marked confidential for reasons of commercial or security sensitivity.

1. Financial Analysis

- The application of the Draft Determination would result in a significant deterioration in DAA's financial profile such that it could not generate sufficient cash flows to support its significant debt requirements and the sustainable profits necessary to fund investment and maintain service levels.
- The Draft Determination implies that DAA will need to raise additional funding when its FFO:Debt ratio is less than [redacted]; in such a scenario DAA will not be able to maintain the funding support or confidence of [redacted] lenders and it creates significant refinancing risks. The reality of these circumstances is not reflected by the Commission in its cost of debt assumptions.
- The Commission has not acknowledged the risks associated with DAA's business and its projected debt levels and has compounded the difficulties by making upside only assumptions across a range of areas. Inadequate consideration of risk would leave DAA with no headroom and seriously undermine its ability to raise additional funding in the short to medium term.
- The financial model used by the Commission to underpin the financial analysis in the draft determination is undermined by inaccuracies and flawed assumptions.

1.1 Financial Returns are inadequate

The draft determination envisages DAA requiring financing at a time when the Commission has forecast the FFO:Debt to be less than [redacted] it also envisages a period in which the return on the RAB is as low as circa 3% [redacted]

In 2007 the Commission "supported" capital expenditure pursuant to Government policy but sought to defer significant remuneration whilst leaving DAA with a de minimus financial profile (by reason of unregulated windfall gains and unregulated income streams) on the assumption that financial scenario downsides did not occur.

Prudent financial management by DAA led to some €1,100 million in facilities being put in place in 2007 and 2008 (a €600 million ten-year Eurobond issue, a €200 million twenty-year EIB loan and a €300 million revolving credit facility maturing mid 2012). The Group also realised some €500 million from the sales of Great Southern Hotels and ARI stakes in Birmingham and Hamburg Airports. These actions put the Group in a strong liquidity position, critical to the successful funding of its €1.2 billion capital programme. But for these actions the Group's cash and credit rating position would now be particularly acute.

Over the past ten years, DAA has developed a funding strategy that has embraced each of the capital markets, bank markets and EIB and has secured long-term debt, much of it with a maturity of between ten and twenty years, on a cost efficient basis. It has created a fixed interest, institutional investor base / following and has developed a major lending relationship with EIB.

A significant weakening in its financial profile and fall in credit rating caused by a flawed regulatory outcome would serve to quickly and unnecessarily undermine this strategy, with potentially long-term and far reaching consequences.

In order to appreciate the extent of the weakening in its financial profile DAA has prepared calculations of the projected return on the RAB and return on equity.

In correspondence, the Commission has confirmed that a projected profit and loss account for the regulated business has not been completed as part of its financial modelling. DAA has carried out a high level calculation of the return before interest and tax based on the Commission's draft determination and utilising the Commission's model. The rate of return (before funding costs) on the RAB has then been calculated[2]. The result of this calculation is as follows:

Rate of return on RAB

	2010	2011	2012	2013	2014
Aeronautical revenue	173.3	177.0	182.6	190.1	199.9
Commercial revenues	127.4	130.6	135.0	141.0	148.9
Opex	(184.1)	(181.9)	(179.8)	(182.4)	(185.5)
Depreciation	(55.6)	(78.5)	(85.2)	(87.5)	(85.3)
Return	**61.0**	**47.2**	**52.5**	**61.3**	**78.0**
RAB reflecting straight line depreciation of T2					
opening RAB	891.0	875.0	1555.7	1510.1	1462.1
Closing RAB	875.0	1555.7	1510.1	1462.1	1416.5
Rate of return on average RAB	**6.9%**	**3.9%**	**3.4%**	**4.1%**	**5.4%**

The result illustrates that even utilising the Commission's benign cost and revenue assumptions, the Commission's approach does not allow DAA a return on the RAB remotely close to the allowed cost of capital. Effectively, this analysis highlights the impact unitisation of T2 Box 1 has on the actual rate of return on the RAB versus the 7% assumed by the Commission in the draft determination as being the appropriate level. Unitisation implies a regulatory deficit of circa €225m over the period, of which circa €50m is in 2011 alone[3], in other words, of the total actual financing and depreciation expense related to T2 Box 1 of circa €295m, which will be incurred, the Commission propose to remunerate only €70m. This level of revenue profiling is not a tenable basis for remunerating a national infrastructure project built pursuant to Government policy.

Using its own financial model DAA has also calculated a return on equity for the group based on the charges as indicated in the draft determination, assuming efficiencies in operating costs, including the costs to deliver them, and lower Capex at a level similar to that proposed by the Commission.

As can be seen from the table below, the return on equity falls from 11% in 2006/2007[4] to

[2] Return is defined as aeronautical revenue, commercial revenue and opex are as per Table 3.1 in the draft, plus the sum of the depreciation on the existing RAB, depreciation on post 2009 capex, and the depreciation for T2 box 1 assuming a 40yr avg life. RAB is defined as Opening RAB, plus T2 Box 1 in 2011, plus Capex, less depreciation calculated as being the sum of the depreciation on the existing RAB, depreciation on post 2009 capex, and the depreciation for T2 box 1 assuming a 40yr avg life.

[3] When the non remuneration of Box 2 is taken into account the deficit is in excess of €250m.

[4] A level attained through profits from non-regulated businesses and prior to the ramp up of the Dublin Airport investment programme.

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Return on Group Equity	11%	11%	8%						

This demonstrates that the Commission has not properly considered the fact that DAA needs to operate on normal commercial terms. It also implies that the Commission may be expecting the exchequer to accept an inappropriately low level of equity return[5]. The Commission through its draft decision would create a situation where the DAA would not generate sufficient cashflows to support its significant debt requirements, nor maintain other than very aggressive gearing and interest coverage levels. DAA is only in a position to continue trading through the current economic downturn as a result of the previous disposals of unregulated assets and prudent financial management in its funding strategy. Given DAA's legislative duty to remunerate its capital, this is not an acceptable outcome, and is certainly not in keeping with the Commission's statutory objectives.

1.2 The Commission's Financial Model

The financial model used by the Commission to underpin the financial analysis in the draft determination is undermined by inaccuracies and flawed assumptions

On an initial reading of the draft determination it was difficult to understand how the Commission was in a position to portray the financial outturn resulting from the determination as relatively positive to DAA, at least in later years. On examination of the underlying financial model, however, it became apparent that this was in part due to inaccuracies in the model and in part to the flawed basis in which upsides to financial outcomes are assumed by the Commission without any cognisance of downside risks or of the costs involved in achieving these.

A number of these issues have been raised by DAA with the Commission through correspondence and some clarifications have been received. DAA proposed a meeting with the Commission with a view to obtaining a better understanding on both sides of the issues arising, due to the technical nature of many of them. However, as the Commission was unwilling to meet with DAA to discuss these and was only prepared to comment on some of the issues raised in correspondence, it is necessary to deal with these comprehensively in this submission.

Some of these issues relate to the individual treatment of building blocks such as operating costs or commercial revenues and are also addressed in the sections dealing with these areas. Examples of the more obvious errors are as follows:-

- Capex related to ARI is excluded from the aggregation of group cash flows and therefore group net debt.
- Dublin's EBITDA for inclusion in FFO was erroneously inflated by applying the inflation for each year as opposed to cumulative inflation
- The cashflow only reflects Dublin's capex in real 2009 terms instead of nominal (again cumulative inflation should have been applied)

[5] This would be in direct conflict with the recommendations to Government from the recently published Report of the Special Group on Public Service Numbers and Expenditure Programmes (An Bord Snip) which states as follows: *"The Group also suggests that there is scope for increased revenue generation within the sector from more regular shareholder dividend payments from the commercial state companies, including from the Dublin Airport Authority, … reflecting profits and gains of these fully state-owned commercial bodies"* (Volume II:Detailed Papers, pg 217)

The table below shows some of the readily identifiable errors. This was already provided to the Commission on 7 July 2009. In response, rather than address the points made, the Commission requested that
"any queries or comments on the Commission's methodological approach, including observations of potential errors, should be submitted to the Commission as part of a formal response to the draft determination"

Worksheet	Item	Issue
FFO_debt	Calculation of Dublin airport EBITDA	All elements of EBITDA, which were calculated in 2009 prices, have been incorrectly inflated using the CPI for each year - cumulative inflation should have been applied
FFO_Debt	Shannon & Cork's EBITDA	The EBITDA reflected for Shannon and Cork is before allocation of Head Office costs. The impact of this is to overstate the Group EBITDA included in the FFO calculation by the proportion of Head Office costs the Commission allocated to these airports
C - Group P&L (DAA model)	FFO : Interest	Currently being calculated on the basis of net interest; correct calculation as used by the rating agencies should be on the basis of interest payable
C - Group P&L (DAA model)	FFO : Debt	Currently being calculated on average debt & cash, correct calculation as used by the rating agencies should be on the basis of closing balances
C - Group Cashflow (DAA model)	Corporation Tax Paid	The model inappropriately uses DAA's forecast tax payable as a proportion of Group EBITDA for the purpose of calculating the revised tax payable. As losses are forecasted for the DAA company in the financial model submitted to the Commission the cashflow effectively reflected the tax paid by ARI only. The only appropriate way to recalculate this figure is to produce DAA's group P&L based on the Commission's assumptions which includes a tax calculation.
C - Group Cashflow (DAA model)	Purchase of tangible fixed assets	Dublin airport capex as included in this calculation has not been inflated for cumulative inflation (i.e. these figures are stated in 2009 real terms when they should be in nominal terms)
C - Group Cashflow (DAA model)	Purchase of tangible fixed assets	Calculation inadvertently excludes ARI Capex thereby leading to an understatement of cash outgoings from the company
C - Group Cashflow (DAA model)	Net Interest	Reflects DAA forecast and has not been updated to include amended interest as calculated by the Commission

The Commission further compounds these errors by assuming that actions envisaged in the draft determination can be achieved at no cost to the business, most notably the achievement of a significant reduction in full time staffing levels. Leaving aside the discussion on whether it is warranted for the Commission to seek such efficiencies in DAA's operations or the appropriate method of remunerating them, it is a fundamentally flawed assumption that the associated costs do not require to be accounted for as cash outflows to the business. Appropriately recognising these costs as cash outflows would further reduce the FFO:Debt ratio.

Notwithstanding the above errors which serve to artificially inflate the key FFO:Debt ratio, the Commission's financial model includes a group cashflow which reflects a new debt requirement [redacted] in 2011 at a time when an FFO:Debt ratio of [redacted] is projected for 2010. Furthermore, with regard to supporting the business in reaching what are pre-agreed de minimus financial ratios for all years the Commission states,

"Such a solution may not even be feasible, since it would require a sizeable one-off increase in prices in 2010 if the DAA was to immediately return to healthier financial position"[6].

In these circumstances DAA will not be able to maintain the funding support or confidence of existing lenders and faces significant refinancing risks. This is completely inconsistent with not only the Commissions assumed 7% cost of capital but also its rating arguments.

1.3 Approach to Risk

The Commission has not acknowledged the risks associated with DAA's business and has compounded the difficulties by making upside only assumptions across a range of areas

In prior submissions, including those made at previous determinations, DAA has set out the nature of the risks facing the business, both in relation to the factors impacting DAA and Dublin Airport and the wider economic environment. It has also been a feature of previous determinations that such risks have been ignored by the Commission and in fact upside only adjustments have been applied to DAA assumptions in a range of areas. While this approach may have been enabled by an economic climate in Ireland where growth forecasts were routinely exceeded for almost a decade, it is striking that the current environment which has seen many of the downsides that were anticipated by DAA arising, has not caused any change in approach by the Commission.

The Commission has:

- Assumed an early recovery of economic conditions and higher levels of passenger growth than any of the industry participants have anticipated;
- Assumed medium term economic growth forecasts that are out of line with current expert views;
- Replaced detailed DAA analyses in the area of commercial revenues with a simplified extrapolation of past trends generating higher anticipated returns which are unachievable;
- Replaced detailed DAA analyses in the area of operating costs with simplified assumptions, including ones not supported by its own consultants (e.g. efficiency target phasing);
- Been notably quick to abandon its simplified approach in instances where individual elements of DAA's commercial revenues or operating cost assumptions were seen to be more favourable than the Commission assumptions. For example, reductions in staffing have been accepted as appropriate in some cases on no greater basis than an assertion by the Commission's consultants that *"on this (limited) basis it appears that the…may have higher manpower levels than necessary"*[7], whereas a commentary *"that manning is tight and may bring into question the ability of the airport to maintain its current service standards with this level of staff*[8]*"* is ignored

[6] CP3/2009, S10.11
[7] Indecon Jacobs Report, pg 23
[8] ibid, pg 20

- Has computed a cost of capital for the business on the basis of maintaining an A rating, while creating an environment where a significant fall in ratings is inevitable and any recovery of rating is contingent on delivering extremely positive outturns 5 years out. Aside from the impact on longer term rates of return for the company, the impact of this is to understate the cost of debt to the business over the period. Increases in the cost of debt in the current uncertain economic environment would have the impact of reducing FFO while at the same time increasing debt.
- Has incorporated claw back for "assumed" remuneration of projects that did not progress as part of its calculation of the opening RAB, but has not allowed retrospective remuneration for projects, previously unforeseen, which it agrees should be allowed in the RAB.
- Has deflated operating cost projections in 2009 by an assumed 1% inflation, but accepted DAA's 2009 Commercial revenue projections unadjusted for this 1%. Given that DAA's forecasts assumed 0% 2009 inflation, this results in an inconsistent approach across the building blocks and an over inflated estimate of FFO.

The Commissions financial model as currently constructed does not lend itself to carrying out any sensitivity analysis to test the impact of changes to any of the Commission's assumptions, for example, passenger forecasts, efficiency target levels, efficiency phasing, or changes to opex, commercial revenue or capex levels. DAA is concerned that the Commission does not appear to have carried out a robust sensitivity analysis on its assumptions; if it has completed this analysis it is not reflected in the Draft Determination. Given the global economic uncertainty and specific issues related to Ireland such sensitivity analysis should be a crucial component of the Commissions analysis.

DAA has carried out its own sensitivity analysis, using its financial model, based on the Draft Determination. For one such analysis DAA has applied airport charges, lower capex and cost savings at similar levels to those indicated in the Draft Determination and assumed a further deterioration of c.10% in passenger numbers. Given the current market volatility and DAA's concerns regarding the appropriateness of the cost and capex assumptions,

The resulting impacts on key ratios are illustrated in the following table.

	2008	2009	2010	2011	2012	2013	2014
FFO:Debt	71%						
Return on Group Equity	8%						

The Commission has not reflected the downside risks inherent in DAA's business, or the financial risk associated with a projected balance sheet containing net debt of circa €1 billion in its Draft Determination. The Commission's Draft Determination cost of capital is wholly inadequate in the context of these risks.

In this context, it is worthwhile bearing in mind that DAA highlighted this eventuality in its response to the draft interim determination in 2007 and extracts of our comments are provided below.

"However, based on DAA's projections, this ratio will be not be achieved in any year between 2010-2014 at the Commission's suggested pricing levels. This is largely because DAA's projections differ materially from the Commission's, primarily in relation to operating costs, commercial revenues and assumptions regarding dividend policy and liquidity policy, as outlined later in this section. This fundamentally undermines the usefulness of the Commission's financeability analysis as it suggests that DAA will not be sufficiently remunerated to meet reasonably incurred costs."[9]

"Additionally, given no increase in charges in respect of a substantially higher capital programme, DAA fears that financial markets might perceive that DAA's improved financial position has been opportunistically used as a rationale to introduce pricing policy changes. The assessment of the regulatory environment as a result may be that it is even less supportive in the longer term and prone to potential "downward financeability" adjustments."[10]

"DAA has previously highlighted the significant asymmetry to the DAA's risk profile of assuming a higher traffic forecast in an interim review which would effectively capture the key upside into the "base case" leaving DAA facing only the considerable downside risks separately identified. In the event, the benefits arising from substantially higher traffic forecasts have been expressly incorporated in the pricing formula in the draft decision without altering the allowed cost of capital for this additional risk. Contrasted with the treatment of operating costs it could reasonably be concluded that the Commission *"cherry-picked" the updated trends identified that provided positive financial signals and ignored those that proved negative."*[11]

"The two sensitivities in which different volumes are applied (10% increase or decrease in 2010)[12] *include the assumption that charges are varied as a result of the volume difference. DAA welcomes the illustration that lower projected volumes would cause* the Commission *to increase airport charges to safeguard DAA's financial ratios. However, in reality this scenario could only apply in the case where the volume difference from current forecast was accurately predicted in advance of the determination for 2010 and incorporated in the determination for that period. This causes a particularly benign interpretation for the downward (volume shock) scenario where a price increase compensates for the loss of revenues from traffic and commercial activities."*[13]

More generally, DAA faces a wide range of potential shocks, which have been highlighted in previous submissions, notably in DAA's 2007 Statement of Case document. The main headings highlighted below provide an indication of the riskiness of the DAA's business at a time when it is carrying a heavy debt burden.

- Economic development and air traffic growth: macro-economic factors impact demand from both business and leisure travellers to and from Ireland, as evidenced over recent times
- Event risks and the difficulties associated with forecasting traffic; given recent announcements by airlines, projected 2010 passenger traffic is already under significant

[9] Response to Draft Decision 21 June 2007 – p15
[10] Response to Draft Decision 21 June 2007 – p20
[11] Response to Draft Decision 21 June 2007 – p25
[12] Figure 14 & 15, CP5/2007
[13] Response to Draft Decision 21 June 2007 – p25

threat, it is also difficult to gauge the impact "swine flu" is going to have on demand in the near future

- Risks associated with operating costs: the fixed and semi-fixed nature of the operating cost base makes responding to change in the short term difficult, this is evidenced by DAA's experience to date in it's efforts to implement a cost recovery programme
- Risk of increased requirements and/or changes in the law for security measures: increased measures regarding liquids introduced in 2006 resulted in increased costs to DAA and impacted commercial revenues from the retail offering
- Risks associated with the operating model for Terminal 2: final decision on services to be included in the operating tender has not yet been made, also with the exception of the tender costs, which the Commission has indicated will be treated as a pass through, significant risk is associated with remuneration of non tendered costs
- Pension Cost Risks: DAA's liquidity, and/ or DAA's credit rating could be impacted if additional pension costs arise. Contributions to the multi-employer pension scheme to which the vast majority of DAA's employees are members are fixed. Following the fall in investment markets the most recent actuarial valuation shows a significant deficit the result of which is that asset coverage for employee pension liabilities was
- Risks on commercial revenues: the economic downturn has impacted the propensity to spend, also at this early stage it is difficult to measure the full impact the recent legislation regarding the sale/advertisement of tobacco products will have on retail spend, however there has already been a downward trend
- Risk relating to the cost of capital/capital structure
- Risks related to the support from and performance of non-regulated business: The current global economic situation has not just negatively impacted the performance of Dublin airport, but also the non-regulated businesses within the DAA Group. To the extent that the non-regulated businesses underperform this could have an impact of financeability at a group level.
- Risk due to airport separation: airport separation decision has been deferred until 2011, however as this date is early in the next determination period, the risks previously communicated remain an issue

1.4 Sustainable Financial Viability

The Commission is required to ensure that DAA will be enabled to operate and develop Dublin Airport in a sustainable and financially viable manner. There are a number of aspects of the draft determination which threaten to undermine the sustainable financial viability of DAA in the short term and therefore generate a result that is inconsistent with the Commission's statutory obligations.

The Commission has not, in the draft determination, provided reasons why the following aspects of the draft determination are consistent with its statutory objective to allow DAA to operate Dublin Airport in a sustainable and financially viable manner:

- Application of a lower cost of capital than was implemented at the last review despite the impact that the economic crisis and volatility in financial markets is having on the cost of debt and equity
- Proposing challenging operating cost efficiency targets but not allowing the significant up-front costs required to achieve such efficiencies
- Adopting a short term view by disallowing capital expenditure that is required for the future development of airport infrastructure
- Basing conclusions on preliminary, incomplete and flawed assessments of individual building blocks and using these to inappropriately replace DAA's detailed analyses
- Incorporating commercial revenue targets that are overly ambitious in the current economic climate but disallowing the investment required to deliver them

- Adopting traffic forecasts that are more optimistic than those put forward by either DAA or airline users and economic growth forecasts that are out of line with current expert views
- Proposing the creation of a costly and administratively complex system to address service quality, despite accepting that existing service levels are appropriate

In addition to the lack of reasoning in the draft determination, the assessment of the impact of the DAA's likely credit rating on its sustainable financial viability is also flawed. The Commission accepts (as it should) that DAA should be allowed to maintain an investment grade. However, DAA strongly disagrees with the Commission that a grade below A is sufficient to ensure the financial viability of DAA. Importantly, the Commission does not assess in the draft determination what investment grade is likely to be achievable by DAA on the basis of the proposals in the draft determination. DAA has carried out this assessment and this indicates that DAA risks a downgrade [redacted] even in *the Commission*'s base case scenario and inevitably in a credible downside scenario. Such a downgrade brings with it serious consequences for DAA's ability to operate Dublin Airport in a sustainable and financially viable manner.

DAA's submissions are reasonable and backed by sound financial evidence. DAA has also explained how the failure of the Commission to properly remunerate DAA for its CIP imposes risks to DAA's financial viability. It would be inconsistent with the Commission's statutory objectives for the Commission to ignore this evidence. Rather, in light of this submission and evidence, the Commission is required to amend its draft determination as it does not have discretion as regards the ability of DAA to operate Dublin Airport in a sustainable and financially viable manner. The Commission must allow for proper remuneration of the CIP.

Furthermore, the draft determination refuses to remunerate expenditure which the Commission itself regards as necessary, for example the upfront investment necessary to achieve certain operating cost efficiencies. By definition, all reasonably necessary expenditure must be remunerated and any refusal to allow such per se breaches the statutory objective of sustainable financial viability.

All the above illustrates that the Commission has adopted an approach which considerably heightens financial risks for DAA. The legislation does not foresee that DAA should be exposed to such a risk level. Consistent with the rationale underlying the State Airports Act 2004 it is rather intended that DAA be enabled to carry out the functions and fulfil its duties with sufficient financial headroom to eliminate the possibility that the Company would be confronted with a financial position that would prevent it operating Dublin Airport in the national interest.

2. Service Quality

- The Commission's assessment of the correct quality of service targets at Dublin Airport concluded that current levels being achieved were adequate, and therefore evidenced that a formal service quality scheme is not required.
- Against this background CAR's proposal to institute a potentially costly and administratively complex service quality scheme is unwarranted, particularly with regard to the three proposed 'airline facing' measures.
- The Commission must ensure that any scheme has been fully planned out in detail prior to its introduction, to minimise the potential for disruption and gaming.
- The Commission's choice of 'passenger facing' measures is for the most part fair and representative, and as reflective of the needs and wants of Dublin Airport's ultimate end users, should take primacy over CAR's proposed 'airline facing measures'.
- Contrary to CAR's assertion, 'Contact Stand Utilisation' is not an agreed SLA, and should not be included in any formal service quality system.
- Given DAA's consistent success in achieving the target for the 'Incoming Baggage System Availability' SLA, active monitoring offers a more efficient approach than introducing a system of financial rebates
- DAA is adapting to a recent step change in the nature of passenger security screening, as a result of a change in user behaviour. Immediate actions have been taken; however it will be some time before the long term impacts are fully understood and neutralised. Under these circumstances DAA believes that the introduction of a service quality rebate on this term is premature.

2.1 The Evidence does not support the Introduction of a Service Quality Term

The Commission's assessment of the correct quality of service targets at Dublin Airport concluded that current levels being achieved were adequate. This is in line with DAA's position that service quality problems are not an issue at Dublin Airport.

Service quality has received considerable scrutiny in the build up to this Determination, with the dedication of both a consultation paper (CP3/2008) and a chapter of the more recent Issues Paper (CP6/2008) specifically to the issue. This has allowed the Commission a significant quantity of detailed feedback from users, stakeholders and interested parties. DAA welcomes the Commission's conclusions on the basis of this consultation that current standards of service meet the requirements of users at Dublin Airport.

DAA acknowledges and agrees that under the current regulatory system, regulated firms are not provided with any strong financial incentives to maintain or improve standards of service quality. However DAA's commitment to customer service has ensured that this theoretical problem has not arisen in practice to date.

Indeed, measures of passenger satisfaction have risen consistently in recent years, in spite of severe congestion and capacity limits. Individual failings have been the result of these resource constraints or exceptional circumstances (such as increased security requirements for example) and have been quickly addressed. DAA has not only fulfilled its duty to provide

adequate service quality standards but has also demonstrated its commitment to continuous improvement in this area. This "welcome trend"[14] has been achieved in the absence of any regulatory involvement or incentives whatsoever.

Given the Commission's acceptance, on foot of a considerable volume of consultation, that current standards of service quality at Dublin Airport are acceptable, there appears to be no justification for the introduction of a service quality term in the price cap.

DAA appreciates the Commission's intention to rely upon data and information which is already collected within Dublin Airport. However this will not guard against the considerable administrative costs which are likely to be generated by any such scheme. In particular the Commission's proposed 'airline-facing' measures are much more likely to be disputed by airlines each quarter, given the considerable sums of revenues at stake. This may mean that a more robust methodology for collecting and collating the data would be required. In addition, the Commission's proposal that its quarterly decision be subject to consultation from all parties would require much more attention than is currently required for existing airline agreements. This reality would be equally applicable to airlines, DAA and the Commission itself.

DAA accepts that the Commission has a statutory objective to protect the reasonable interests of users of Dublin Airport. However, in its response to CP6/2008, DAA reminded the Commission of its statutory obligation to have due regard to imposing the minimum restrictions on DAA. The Commission countered that it had an obligation to have due regard to the levels and quality of services at Dublin Airport, and that one such objective "does not cancel the other out"[15]. To suggest that DAA was arguing such a position is misrepresentative. Rather DAA argued that, while the Commission has a statutory obligation with regards to service quality, given that service quality is not a problem at Dublin Airport and in light of the Commission's obligation to impose the minimum restrictions, a formal link to the price cap was not warranted. This position has been subsequently reinforced by the Commission's implicit agreement that current standards of service are, at a minimum, acceptable at Dublin Airport. In addition section 5(4) and 32(9) of the Aviation Regulation Act require the Commission to adequately reason its decisions. No reason has been given as to why a service quality scheme is justified at Dublin Airport.

In addition DAA notes the Commission's comment that "many other economic regulators have implemented similar (service quality) schemes"[16]. DAA agrees that this is the case and considers it illuminating to consider briefly the implementation of such a scheme by one such body - the UK Civil Aviation Authority (CAA).

The CAA has introduced service quality schemes in Heathrow, Gatwick, and most recently, in Stansted. However all such schemes was the result of Competition Commission reports which:

a) Concluded that a course of conduct has operated or might be expected to operate against the public interest;
b) Specified effects adverse to the public interest which that course of conduct had or might be expected to have; and
c) Concluded that the adverse effects could be remedied or prevented by the imposition of conditions.

[14] The Commission's description of DAA's historical performance on the proposed 'passenger facing' measures, Para 5.17, Pg. 19, CP3/2009
[15] Para 5.24, Pg. 20, Cp6/2008
[16] Para 5.24, Pg. 20, Cp6/2008

Such reports ensure that due consideration is given to the question as to whether a service quality term is justified at each individual airport. Accordingly, a penalty system to incentivise a better level of service was introduced at Stansted only because Stansted Airport Limited was independently found to have failed to deliver an adequate level of service. By contrast the Commission has failed to replicate any of the above findings, and indeed, by proposing targets which are currently being achieved, has clearly indicated DAA has not failed to deliver an adequate level of service.

DAA reiterates its support for the Commission's proposal to publish information on DAA's performance. This would represent the optimal response to a theoretical issue which has not arisen in practice. Publication of DAA's performance in the proposed area would allow close public scrutiny of service quality at Dublin Airport. In the event that DAA's commitment to customer service deteriorated as a result of the current regulatory incentives, it would become quickly apparent via service quality results published. The Commission would be in a position to ascertain this quickly and introduce a remedy, even within a Determination period if required. This approach would ensure that the Commission was intervening to address a problem which existed in reality, rather than in theory.

If the Commission is minded to continue with this scheme, DAA would ask the Commission to explicitly state what benefits such a scheme is expected to bring to Dublin Airport users, in the context of service levels which are already sufficient, and which have shown continuous improvement over the last number of years. There is no overriding necessity to introduce a measure to incentivise DAA to improve service levels at all. Accordingly, a service quality scheme could not possibly represent the 'minimum restrictions' on DAA and so the balance of factors evidences that the Commission has no legal basis upon which to introduce a formal price cap link.

Finally, DAA also welcomes the Commission's decision to link the provision of service quality to the costs associated with the delivery of such services. In particular DAA agrees with the Commission's suggestion that users should price any increases (or decreases) in service quality that they might demand. Given the Commission's satisfaction with current levels of service quality at Dublin Airport, DAA would expect that any amendments to the proposed targets in the Commission's final Determination would be solely in response to users demanding new and previously unarticulated levels of service quality. Thus any attempts by users to 'raise the bar' in this regard would be accompanied by corresponding increases in operating expenditure allowances.

2.2 The Implementation of a Service Quality Term

If the Commission is minded to continue with the implementation of a service quality scheme it is essential that the Commission articulates in detail how it will operate, prior to the start of the new Determination period in 2010.

DAA is keen that any disruption or opportunities for regulatory gaming that this scheme would present to all parties, if implemented, would be minimised. Key to this would be a commitment by the Commission to set out clearly and definitively the details of the scheme. If this is not possible in the Commission's final Determination, DAA would expect the Commission to engage in close consultation with DAA and any other interested parties to ensure a smooth implementation.

Of particular concern to DAA are the three 'airline facing' measures. In the attached Detailed Supporting Document II, DAA has set clear definitions of each of the three proposed "airline facing" measures, detailing how they are calculated. Some of the events and circumstances

which are out of DAA control, and should therefore be grounds for the waiving of any penalties, are also outlined.

The Commission has proposed that it will indicate each quarter whether it is minded to waive the implementation of penalties in circumstances where targets are not met. DAA is prepared to identify and detail the extenuating circumstances under which a penalty should be waived, as part of its submission of quarterly results to the Commission. DAA believes this is a more appropriate mechanism than the Commission deciding in isolation whether penalties should be imposed or not, and then putting its decision to consultation.

DAA also notes that the Commission is proposing an asymmetric penalty regime, while simultaneously "hoping"[17] that DAA would increase service quality levels beyond the Commission's proposed targets regardless. The Commission's asymmetric proposals are in contrast to comparator service quality schemes operated by the Civil Aviation Authority, and unnecessarily increase the regulatory risk faced by DAA. Any service quality regime implemented by the Commission should offer symmetric incentives to DAA.

The Commission has also proposed that penalties be paid back to airlines within 45 days of the end of the regulatory period. A similar timeframe is proposed by the Commission regarding the annual over-recovery of the price cap. DAA has addressed this issue in Section 8.2. In summary:

- The 45 day period proposed is inconsistent with the timelines for the preparation of audited financial information.
- The Aviation Regulation Act 2001 allows 6 months after the accounting year before submission of regulated accounts to the Commission. This would offer a more realistic, fairer, and more consistent method of administrating any penalties in a subsequent year.

The proposal that transfers would be in lump sum penalties rather than via a lower price cap also raises questions which will need to be clearly addressed by the Commission prior to implementation, for example:

- Can the Commission confirm that the definition of a 'user' relates strictly to airlines operating at Dublin Airport?
- If so how does the Commission propose to allocate any penalty between airlines?
- Who should receive an airline's allocation if it goes out of business, or ceases to operate out of Dublin Airport?
- Will DAA be compensated for the administrative costs of making multiple payments many of which are likely to be for nominal sums?
- Should penalties be paid to airlines who have defaulted in payments due to DAA?
- Can penalties be used as 'credit notes' for users that have a debtor account with DAA?

2.3 Optimal Approach to Service Quality

DAA views the introduction of a formal price cap link to service quality as being a suboptimal solution. DAA outlines some more efficient alternatives, which marry the theoretical issues with the practical realities to produce more efficient approaches.

A fundamental principle of regulation is that intervention should be proportional to the problem which is to be remedied. DAA's performance to date is impressive and current service levels at Dublin Airport have been accepted by the Commission as, at the very least,

[17] "*It is hoped that the DAA might surpass the targets comfortably*" Para 5.16, CP3/2009

acceptable. The Commission should not underestimate the considerable effort and expense that the implementation and maintaining of an entire service quality price cap link will entail. This will be borne by DAA, airlines, and the Commission itself. Ultimately it is passengers who will pay the price of the scheme.

Given the potential costs associated with implementation, and in light of Dublin Airport's performance to date, DAA believes that a regulatory 'light touch' is both a more appropriate and a more efficient approach to the issue. Below DAA outlines alternative approaches to service quality that the Commission could adopt. The alternatives outlined below are ordered by decreasing optimality. I.e. the first proposal is the first-best solution.

- The service quality measures proposed by the Commission, both airline and passenger-facing, should be monitored and published by either the Commission or DAA. As outlined above, this would allow greater transparency as to DAA's performance, and would facilitate the introduction of a formal service quality term in the price cap, were it to become apparent that DAA had consciously lowered service standards in an effort to beat operating expenditure targets.

- If the Commission is minded to continue with some service quality scheme, solely the 'passenger-facing measures' should be formally linked to the price cap. The more complex 'airline-facing' measures could be monitored and the results published, at least initially. This approach would ensure that any service quality term introduced would address the key concerns of end users, while simultaneously avoiding the associated administrative costs and any regulatory disputes from airlines. This would be due to the simplicity of the Commission's proposed ACI measures, which directly reflect passenger's opinions, and which are incontestable by airlines.

- If the Commission is minded to continue with a scheme, and to formally link the price cap to both 'airline facing' and 'passenger facing' measures, the distribution of penalties should be more heavily weighted towards 'passenger facing' measures. The current regulatory process, by its nature, allows little meaningful input from passengers. Where their input is possible, the Commission should ensure that it is significant and has a real impact. Giving preference to ACI survey results would be a realistic and fair method of redressing the current imbalance. A heavier weighting for 'passenger facing' measures would reduce the incentive for all parties to dispute or question the results of the more complex 'airline facing' measures. This could reduce some of the costs associated with any such scheme. DAA would propose that, under such circumstances, the ratio of penalties should be weighted 75:25 in favour of 'passenger-facing' incentives, instead of the proposed 50:50.

2.4 Passenger facing measures

DAA generally supports the Commission's use of ACI results to monitor service quality. DAA believes that, with a few minor alterations[18], the Commission's choice of measurements and the weights attached to them offer a fair representation of service quality at Dublin Airport.

DAA welcomes the Commission's decision to adapt ACI passenger survey results to monitor service quality. ACI passenger surveys reflect the opinion of the ultimate end users of Dublin Airport in a comprehensive manner. Due to their large number, the voice of passengers is

[18] Set out in Detailed Supporting Document II

often underrepresented in the current regulatory system. Any innovation which directly reports the opinions of Dublin Airport passengers is to be encouraged.

Overall DAA believes that, if a full service quality term is introduced, the total weighting given to 'passenger facing measures' should be higher relative to 'airline facing measures', as the ACI measurements offer a broad representation of the ultimate service quality that DAA provides to its end users-the passengers. DAA has suggested a weighting of 3% versus 1%, instead of the currently proposed 2% for both passenger and airline facing measures.

2.5 Airline Facing Measures

2.5.1 Contact Stand Utilisation for Departing Aircraft

DAA does not support the inclusion of this measurement as a term in any service quality scheme. It is not a performance metric, is heavily dependant upon capital expenditure allowed by the Commission, and has no clear or defined target endorsed by users.

DAA is surprised and concerned at the inclusion of a measurement for contact stand utilisation for departing aircraft in the Commission's proposals. Contrary to the Commission's assertion that the airline facing measures are *"derived from the service level agreement DAA has with the airlines"*[19]*,* this measure is not in fact incorporated in any SLA.

There are serious problems regarding the proposed target. As the Commission will be aware from the interactions during the capex consultation process, despite numerous requests, DAA has been unable to elicit from users what their required standard of service is in this area. Failure by users to articulate a specific and clear target should preclude this term from any service quality scheme.

It is because of these issues that, the percentage contact stand utilisation by departing aircraft is considered an operational metric rather than a performance metric. While low cost carrier business models may require the quick turn-around that contact stands allow, the same is not necessarily true for other elements of Dublin Airport traffic. Were contact stand utilisation for departing aircraft to reach 100%, it is not clear that this would necessarily indicate the optimum level of service.

Stand allocation is a complex process, in which contact stand provision is but one element. Any blunt contact stands availability metric risks producing perverse incentives which might compromise service quality. For example, to reach the proposed 90% target, DAA might be incentivised to allocate a (more expensive) contact stand where a remote stand was preferred. Alternatively, in the event of the scheduled plan not being adhered to, DAA might be incentivised to allocate an alternative contact stand at a Pier which is far from the scheduled stand. This would entail an airline or an airline' agent having to move its staff and passengers to the new stand at short notice, where it may have been more beneficial to provide a closer and more accessible remote stand.

DAA notes the Commission's decision not to entertain a 'congestion term' in any service quality scheme, on the grounds that the Commission wished to focus on service areas which were not dependant upon capital investment. Whether through maintenance or the provision of new stands, the availability of contact stands is inextricably linked with capital investment.

[19] CP3/2009, para 5.4

By introducing the prospect of a contact stand metric, the Commission is being inconsistent with its own rationale.

The Commission has also noted that this measure is being proposed as a result of representations by DACC and Aer Lingus. However, these parties opposed the inclusion of capex proposed by DAA for the reconstruction of stands and for connectivity to Pier B, projects that would have a direct impact on DAA's ability to achieve the targets set.

This raises a broader issue as to the nature of the proposed metric. DAA's ability to increase contact stand availability is, by definition, clearly linked to its ability to provide additional pier facilities and to provide necessary maintenance for those currently in existence. Under the current regulatory regime, consultation with users forms a large component of the Commission's decision on whether or not to allow DAA collect remuneration for such works. If users propose a target for a metric that is higher than is currently being achieved, the Commission should not accept their position in isolation. DAA cannot be expected to meet certain levels of contact stand provision while simultaneously being opposed in its efforts to make the capital investment required to reach that level.

2.5.2 Percentage of Time Incoming Elements of the Baggage Handling System Available during Hours of Operation

DAA welcomes the Commission's decision to exclude the outgoing section of the baggage system, which will significantly reduce the complexity and costs associated with any service quality term. DAA's performance to date on this metric shows that a service quality term is not necessary at this time.

DAA note that while users have highlighted to the Commission (in passing) the importance of a measure for the baggage scheme in any service quality scheme, they have at no point expressed any dissatisfaction with DAA's performance in meeting the SLA target to date. Indeed, as has been shown to the Commission in DAA's response to CP3/2008, DAA has consistently maintained a result well in excess of the SLA target.

DAA would therefore suggest, consistent with its suggestions on a wider approach to the issue of service quality, that the Commission actively monitor this issue at present. The SLA agreed between DAA and airlines would appear more than sufficient a mechanism to maintain adequate levels of service quality without the need for any regulatory intervention.

DAA would again reinforce to the Commission the potential costs associated with integrating the current SLA into a formal service quality term. If the data measurement and target calculation are to become the basis for quasi-contractual financial transfers, with associated challenges by users or DAA each quarter, it is likely that a more robust and auditable recording system may be required.

2.5.3 Percentage of time that security passenger search time is no longer than 7 mins

Changed user behaviour has resulted in a step-increase in the work load associated with passenger screening in the last number of months. As a result DAA's SLA performance has suffered. DAA has reacted to this and has enacted both short and long term solutions which have delivered some improvement; however it will be some time before the final impact of this step increase has been both identified and

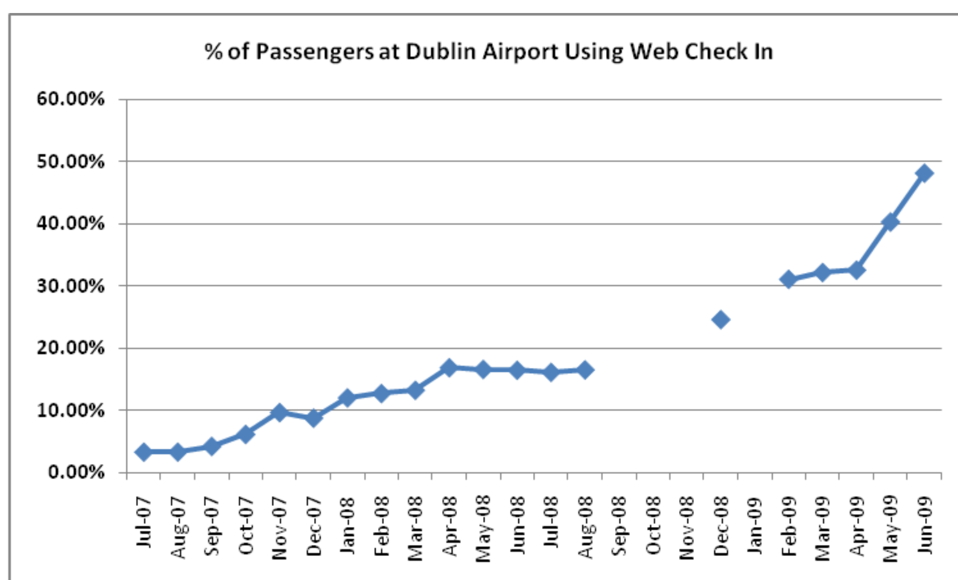
neutralised. For this reason DAA believes that, in line with the other SLA-related measures, passenger screening as a measure should not be subject to a service quality penalty at this time.

In recent times, the nature of passenger security screening has changed. Specifically a big increase in passengers using web check-in and the increase in carry-on bags has had a considerable impact upon the work load being demanded at passenger screening, and would appear to be potential causes of the decrease in SLA results in recent times. Both of these developments are a consequence of airlines levying extra charges on passengers to raise additional revenues. This step change will take some time to fully understand and address. The Commission has stated that it is minded to exclude penalties in the event of increased security requirements. DAA has recently experienced a significant and long term increase in what is required of its security screening services. Given the timeframe required to fully internalise this increase, DAA proposes that, rather than introduce a service quality scheme which immediately requires exceptions and the waiving of penalties, the Commission actively monitors the situation via publication of DAA's result on this metric.

Details of the changes in user behaviours which have impacted upon the nature of security screening in recent times are set out below.

- Increased Web Check-In

The last year has seen a huge increase in web-check in, as a direct result of additional charges being levied on passengers who would otherwise wish to check-in at the terminal. This increase is presented in the graph below.



Source: DAA. September –November 08 & January 09 incomplete due to technical difficulties.

The impact of web check-in is two fold.

1. Security screeners must scan a web boarding card through a machine rather than undertaking a quick visual check. This process takes double the time than processing a traditional manual boarding card (8 seconds versus 4 seconds), and is hampered when a passenger's print out is of poor quality, or if a passenger prints out a duplicate boarding card.[20] Such problem cards take an average of 28 seconds each to resolve. The checking of

[20] This occurs when a passenger prints out the same boarding card twice in error, rather than printing out the separate boarding card for their travelling companion.

boarding cards is an essential component of the screening process, and the advent of web check in has led to it becoming, at times, a serious bottleneck in the overall process.

2. More seriously, web check-in passengers have different and more unpredictable arrival patterns. Security staff rosters are built to accommodate anticipated demand, to ensure optimal efficiency. Anticipated demand is built upon the flight schedule, the anticipated load factors of those scheduled flights, and, crucially, the anticipated arrival profile of the passengers. This is used to plan for when security screening should 'ramp up' to meet the highest peaks.

It would appear that web check-in passengers are inclined to arrive much closer to their scheduled departure time. As well as the difficulties involved in staff planning which arise from the unpredictable nature of web check-in, if passengers are increasingly arriving closer and closer to their departure time, then the peaks in demand are becoming even 'peakier'. This means that, on a rolling hour basis, increased pressure is placed on security screeners' processing rates.

- **Bags per passenger**

One of the main areas where airlines have increasingly imposed auxiliary charges has been checked in baggage. Increased charges, stricter weight limits and higher penalties for breaching those weight limits have resulted in customer's increased use of carry items through security where possible. While this impact has been mitigated somewhat by stricter cabin baggage allowance, it remains the case that there has been an increase in item screenings per pax from 1.19 when T1's processing capacity was last calculated, to 2.8 at present. The increased workload has an obvious impact upon DAA's ability to meet its SLA target.

Steps Taken by DAA to Date

DAA has established a working group specifically devoted to addressing the issues raised above. Both short and long-term approaches are being adopted to deal with the challenges posed. In the short-term, the following are examples of steps that have been taken:

- Advertisements have been taken out in the media advising passengers to arrive 90 minutes prior to departure. This initiative has not been supported by all users.21
- Extra staff have been allocated at landside/airside divide to speed up boarding card checking
- Ergonomical changes have been made to the layout of screening equipment, to allow increased screener productivity.
- Engaging with users to facilitate as much as possible the changing requirements. Not all users have cooperated in this process. For example, Ryanair recently introduced new barcodes for its online boarding card which Dublin Airport card scanners had difficulty reading. These were introduced unilaterally and without any consultation or forewarning. This resulted in longer scan times, a higher incidence of problem cards, and longer processing times.

In the long-term, a strategic approach is being taken to gain a complete data and analysis-backed understanding of both the queuing process and the impact of external factors upon that process. This knowledge will then be used to develop sustainable long-term

[21] See Ryanair's press release on 14/06/09 where passengers are advised to arrive 45 minutes before a flight, on the grounds that DAA simply wishes to 'target passengers' wallets'.

improvements in how passengers are processed at Dublin Airport. Examples of work currently being undertaken include:

- A drive to improve and make systematic data collection on all elements of the screening process.
- Analysis of web check in passengers to attempt to quantify their arrival patterns where possible.
- The creation of a new planning tool which seeks to identify optimal staffing levels at different times of the day. This ties in with the above two work streams, and entails identifying the emerging new patterns of peak demand, and then identifying the correct resources to devote to these patterns.
- DAA is currently trialling an automated method of monitoring queue levels to provide a much more detailed picture of queue performances. Initial tests indicate that daily observations could be in excess of 3000, versus the average of 112 currently compiled each day when calculating the SLA.

The short term efforts have increased processing rates and have contributed to an increase in queue performance in the immediate term, but it is the longer term efforts which will ultimately allow DAA to fully understand and address the various impacts which have been driven by changes in airline's behaviour. DAA are confident that the problems surrounding these issues can be addressed in a manner which will bring a deeper understanding of the queuing process, and deliver long-lasting benefits to Dublin Airport passengers. However these solutions will take time to emerge. In the meantime, publication of SLA results, on a monthly or a quarterly basis, offers both the Commission and all stakeholders the opportunity to monitor DAA's efforts to address the recent step change in the screening process. DAA is currently grappling with a situation not of its own making. The changes in operations by airlines outlined above are being specifically carried out to increase their own auxiliary revenue streams, and it would be perverse if DAA were to find itself penalised as a result of these changes via the introduction of service quality penalties.

DAA would also point out that airlines cooperation is required to address these issues and subsequently provide the optimal level of service quality to passengers. In particular close consultation is required to ensure that airline and DAA efforts compliment rather than conflict with each other. As has been outlined above, even the initial short term countermeasures taken by DAA to date have been hampered by a lack of cooperation from individual users. Plans to increase screening capacity for the summer period in 2009 were opposed by DACC. The Commission must ensure that airlines are not disincentivised to work with DAA in improving queue performance.

3. Passenger Forecasts

- The Commission has adopted its own traffic forecast for the purposes of the draft determination. No rationale is provided as to why this is viewed by the Commission as a more reliable estimate of demand than the DAA's forecast or indeed that of the DACC.
- DAA notes that the Commission's forecasting methodology recognises GDP as the primary driver of traffic, but this is applied in a considerably more simplistic manner than normal by using a global GDP elasticity figure of 1.
- DAA suggests that the Commission should revert to use the DAA forecasts as in previous Determinations. Should it not do so, it should protect DAA from the volume risk associated with its forecasts deviating from actual traffic in future.
- DAA suggests that the Commission should revert to it closer to the final determination for an updated view of the baseline for 2009 and the forecast for 2010-14 or at a minimum, take account of the current views on the rate of economic decline and potential for subsequent recovery.

3.1 The Commission's Approach to Traffic Forecasts

The Commission is aware of the efforts made by the DAA to develop a joint forecast with the DACC. It is regrettable that it was not possible to develop an agreed forecast, although the level of game-playing by the airlines in the course of the process was itself instructive. At the same time, no rationale has been provided by the Commission as to why, having participated in the forecasting process, it felt it necessary then to undertake a separate forecasting process itself.

The methodology employed by DAA is at this stage very well understood both by the Commission and by the DACC. The underlying assumptions are accepted by all parties (with the exception of the assertion by the DACC that additional cost based adjustments should be made, a point which has not been accepted by the Commission). Hence, DAA is somewhat surprised that, after encouraging the DAA and DACC to engage in a detailed and intensive forecasting consultation process, it has nonetheless developed its own independent forecast. This seems to undermine and render redundant the exercise of developing a forecast between the DAA and DACC, which involved a significant level of interaction and a substantial commitment of resources, particularly on the part of DAA.

The Commission's rationale for doing this is clearly not to employ a more expert and sophisticated approach, as in fact the methodology employed by the Commission is, by virtue of more generalised assumptions, much more simplistic. It is not clear to us why the Commission has decided to substitute a more detailed, well understood methodology with its own approach. DAA would question the logic of replacing a forecast derived on the basis of industry interaction and associated expertise and experience in this fashion.

In relation to the assessment of the sizing of T2 in the 2005 Interim Determination, the Appeal Panel has decided:

> *"In this respect it is the Panel's view that it is not sufficient for the Commission to simply state that it adopts its consultant's views over the views of the DAA. It must state why this is so."*[22]

Accordingly, if the Commission intends to use its own passenger forecasts in the final determination it must clearly and transparently set out why these forecasts are appropriate and it must also state why it has chosen to adopt these forecasts over the forecasts of DAA. It is also striking that the forecast adopted by the Commission is higher than those produced by both DAA and DACC.

The most simplistic assumption made by the Commission is to apply a GDP elasticity of 1 across all markets. It should be clear to the Commission that some markets react differently to growth in the economy than others. The UK is a mature market, with Dublin already having long-standing links to most destinations in the country. It is unlikely that there could be a lot of growth in this market in future. Most of the total market growth in recent years has come from the Rest of Europe (excluding Domestic and UK). This has been reflected by this sector's increasing market share. Assuming all markets have the same elasticity effectively means that there will be no change in market share going forward, which clearly is not likely, as the Rest of Europe is expected to continue to grow faster than the UK, while Long Haul is also expected to grow reasonably fast, with the domestic market actually declining[23]. Ignoring these different dynamics is not a robust approach.

Similarly the Commission is ignoring the growth rates in all other economies. Over the last 10 years, passenger traffic has been primarily driven by growth in the Irish originating market. Thus, there was a close historic relationship between Irish GDP rates and overall Dublin airport traffic growth. Future growth may depend more on non-Irish originating passengers given the current difficulties in the Irish economy. While the latter will remain the leading driver of growth, the rates of growth in the UK, Rest of Europe or the US markets will be different to the Irish economy and to each other. This may, have an appreciable effect on traffic. Ignoring this driver is again not robust.

The simplified approach used by the Commission can at best be seen as a useful cross check of DAA's more detailed analysis but replacing a more detailed forecast with a more generalised one is without merit.

[22] Decision of the Aviation Appeal Panel in relation to DAA's appeal of the 2005 Interim Determination (23 December 2008), page 85.

[23] Proposals by the McCarthy report regarding the abolition of PSO funding when current contracts expire could well hasten this.

3.2 Projected Traffic Levels for 2009

It should be noted that risks identified at the beginning of the year have materialised to a greater extent than expected. At the end of 2008, the ESRI were projecting a GDP decline of 4% in 2009. This was the level assumed by the DAA when producing its forecast. However, the economic picture continued to deteriorate and ESRI projected -8% in April. It is only now that economic projections for 2009 are beginning to stabilise (see table below).

Source	Forecast Date	2009	2010	2011	2012	2013	2014
Central Bank	Jul-09	-8.3%	-2.7%				
ESRI – QEC	Jul-09	-7.9%	-2.3%				
OECD	Jun-09	-9.8%	-1.5%				
Central Bank	Jun-09	-9.0%	-3-3.5%				
CAR Assumption	Jun-09		-1.1%	2.0%	3.0%	4.0%	5.0%
IMF	Jun-09	-8.5%	-3.0%	1.0%	2.3%	2.6%	2.6%
Goodbody Stockbrokers	Jun-09	-8.7%	-4.6%				
Davy Stockbrokers	May-09	-7.9%	-2.6%				
EU	May-09	-9.0%	-2.6%				
Central Bank	Apr-09	-6.9%	-3.0%				
ESRI	Apr-09	-8.3%	-1.1%				
Dept of Finance	Apr-09	-7.7%	-2.9%	2.7%	4.2%	4.0%	
Ulster Bank	Mar-09	-8.0%	-3.5%				
Goodbody Stockbrokers	Feb-09	-6.0%	-2.5%				
Fitzpatrick's (DAA)	Jan-09	-3.5%	-1.0%	1.0%	2.0%	4.0%	4.0%
Central Bank	Jan-09	-4.0%					
ESRI – QEC	Dec-08	-3.9%					
ESRI – MTR	May-08	3.1%	4.6%	3.7%	3.7%	3.6%	3.5%

Unsurprisingly, this further decline in the economic state between Jan 2009 and Apr 2009 had a further impact on traffic in Dublin Airport. Aer Lingus and Ryanair have both made further negative adjustments to their capacity from Dublin which will reduce traffic this winter. See table below.

Date	Airline	Reduction
30-Jul-2009	Ryanair	Reduced Dublin based fleet from 16 to 14 for the winter
27-Jul-2009	Ryanair	Suggested 20% reduction in traffic at Irish airports
17-Jun-2009	Ryanair	Reduced Dublin based fleet from 17 to 16 for the winter
12-Jun-2009	Aer Lingus	Ending of both San Francisco and Washington for the winter schedule.
12-Jun-2009	Aer Lingus	Reduction in Dublin short haul based fleet from 24 to 22 for the winter
3-Jun-2009	Malev	Withdrawing from Dublin for the winter season
Apr-Jun	Charter	Further reductions in capacity. Charter traffic decreased 34% for 2009H1

Further hindering work on the forecast is the fact that Ryanair's public announcements frequently end up not reflecting their actual activity. This means that Dublin Airport has to make its own judgement about the level of activity Ryanair will actually carry out, increasing the uncertainty level.

Season	Actual FR Pax Reduction	Announced FR Pax Reduction	Actual FR Flight Reduction	Announced FR Flight Reduction
Winter 08/09	-4%	-14%	-3%	-12%
Apr-Jun 09	-10%	-20%	-9%	-18%

Depending on the actual level of Ryanair reductions over the winter, we would expect traffic to end up somewhere between [redacted] passengers for 2009. The DACC forecast for 2009, which one might have thought would be the most accurate, since the expectations for the initial year are directly driven by airline plans, is now in fact the most inaccurate, confirming that there was extensive game playing by the airlines. This game playing can be further seen by the timing of Ryanair's announcement that it would be reducing services on the 17th-June, the day before the Commission's determination was released, leaving the Commission with no ability to review its numbers. Notably, it has also not released details of its reductions for this winter, making it very difficult for Dublin Airport to make any clear judgement of the expected throughput for the end of the year/beginning of 2010.

3.3 GDP values used in Forecast

The rate of change in various GDP estimates in the current uncertain global economic environment is a factor on which the Commission has commented in its discussion, and indeed was the subject of much consideration by the DAA in the development of its forecast.

Like DAA, the Commission has chosen to base its position on independent expert commentary rather than creating its own projections of GDP. Indeed, for its 2010 projections, the Commission has used the GDP projection extracted from the last quarterly ESRI report, data DAA has also used in previous forecasts. However, DAA has serious qualms about the specific values used by the Commission in the years 2011-2014, as despite the ESRI having presented its recent figures specifically in the context of a recovery scenario, the Commission has inappropriately used these data as a centreline (i.e. most likely) scenario.

Such a scenario does not appear to be very likely based on current information. Since DAA commissioned its expert advice from Fitzpatrick & Associates, economic indicators have deteriorated further. Expectations have grown steadily more negative both about the depth of the recession, and the ability of the economy to subsequently return to rapid and sustained growth. This can be seen, for example, by the downwards revision of the OECD, the IMF and indeed the ESRI's own short term forecasts. Table 2.1 above extends the

material presented in Table 6.2 of CN5/2009. The most recent views of the IMF and OECD in particular, suggest that although Ireland will return to growth, the rate of growth will be slow for some years, with GDP growth in 2014 at 2.6% where the Commission has used 5%. For this reason, DAA considers that the GDP values proposed by the Commission are too optimistic in each year of the analysis, and should be revised downwards. We note that the Commission had indicated that it would continue to monitor macro-economic forecasts and adapt its forecasts accordingly, and it may have intended to amend the current assumptions in any event.

In the current simple model from the Commission, the impact of adopting the IMF forecast would be to reduce traffic projections by a total of around 4.5m passengers over the 5 years to 2014. Given that, as the period progresses, the gap between forecasts widen, using this forecast would result in a significant risk for the DAA. Especially since, at the end of the period, the Commission is portraying DAA as achieving higher financial ratios.

Furthermore, given the unlikelihood of reaching 21.0m passengers in 2009, applying the IMF forecast numbers to a traffic base of 20.4m (for example), would decrease the total projections for 2010-2014 by another c.3m passengers.

While DAA has not updated its forecast given the ongoing turbulence, it would expect that, based on the factors that it knows about (reduced GDP, capacities etc), traffic may only exceed 22m passengers in 2014. This would correspond to a reduction of at least 4m passengers in our total forecast for the 5 years compared to DAPF09-04 (or on average c0.8m less passengers every year). In view of the current volatility in the market and the frequency of airline announcements, DAA would suggest that the Commission revert to it after the peak summer months for results of year to date traffic performance and an updated view of the baseline traffic levels entering the next determination period. At a minimum, the Commission must take account of the lower economic estimates in the meantime.

3.4 Volume error effect

Given that the Commission has been present at and fully aware of the detailed forecasting methodology employed by DAA, but has nonetheless proceeded to use its own more optimistic forecast for the purpose of the draft decision, DAA is of the view that it is not reasonable that DAA should then be expected to carry the volume risk arising from the use of projections which are not consistent with those of the DAA. DAA suggests that in this case, it would be reasonable to make provision for a mechanism to compensate DAA if the traffic outturn is lower than the Commission's projections. Given that DAA has gone to great efforts to create a process in which both the Commission and DACC were involved, it should not be forced to live with the consequences of any errors made by the Commission in a separate and independent process.

3.5 Cost-sensitivity adjustments

We note the Commission's comments in paragraph 6.8 regarding the requests from airlines to superimpose on the existing forecast the dampening effects of a number of factors which are likely to increase airline costs in coming years. DAA believes, in line with the Commission's statements, that inclusion of such factors requires a level of information which airlines are either not willing or able to provide, and a fundamental rule of forecasting is that if you do not have good data, you do not include the parameter.

4. Operating costs

- The Commission's overall evaluation of the efficiency of DAA's operations at Dublin Airport stems from an incomplete and flawed assessment undertaken by Indecon Jacobs, which includes inappropriate use of benchmarking data to misrepresent the actual efficiency currently achieved by DAA.
- The Commission's assumption regarding no real wage growth during the five year determination period is not viable. This assumption does not reflect the reality of existing terms and conditions of much of DAA's workforce or recognise the legal issues involved, the fundamental shift in the industrial relations climate or indeed the upfront cost that would be required to bring about the change implicit in the assumption.
- The Commission should acknowledge the significant cost burden required to meet the FTE efficiencies proposed in the Draft Determination and should remunerate DAA for this cost on an upfront basis. Alternatively, the phasing of the implementation of any cost efficiency targets set by the Commission should be over a more achievable timeframe as recommended by Indecon Jacobs.
- DAA welcomes the Commission's proposal to treat the T2 tender cost as a pass through in the price cap. As part of the final determination, all assessments for which CAR will have information (e.g. exogenous costs) should be quantified in terms of their impact on the price cap. This will give greater clarity to users, DAA and investors regarding future price path, and comply with statutory requirement that the CAR determination be reasoned and transparent.
- CAR should engage with DAA to ensure any assessment of costs associated with non tendered functions within T2, and any adjustment to costs in T1 is based on factual analysis.
- DAA welcomes the Commission proposal to introduce a rolling scheme for opex; however for such a scheme to encourage the correct behaviour the efficiencies incorporated into the price cap need to be realistic, equitable and achievable.
- DAA believes that the cost of the provision of PRM services should be allowed as a pass through outside of the price cap.

4.1 Commission's Assessment of the Efficiency of DAA

The Commissions overall evaluation of the efficiency of DAA's operations at Dublin Airport stems from an incomplete and flawed assessment undertaken for it by Indecon Jacobs (IJ).

DAA welcomes a bottom up analysis of its operating costs, where such an analysis is carried out at a detailed level with sufficient interaction with the business to ensure a thorough understanding of the business, and to ensure the approach taken, and conclusions resulting are not flawed. This has not been DAAs experience with the bottom up analysis as carried out by Indecon/Jacobs.

Its approach includes the inappropriate use of benchmarking data to misrepresent the actual efficiency achieved by DAA in 2008. The preliminary report also contains numerous factual errors and inaccuracies as well as assessments, the basis of which is unclear or ambiguous.

The approach to top down benchmarking in the IJ report is fundamentally flawed in a number of respects. Nonetheless, DAA welcomes the confirmation in the IJ analysis that operating costs per passenger at Dublin Airport were the second lowest of the sample of comparator airports in Europe in 2008. Indeed the chart published indicates that the level of opex per passenger was c20-25% lower than the mean value in 2008 and up to 50% lower than certain airports. This outcome should come as no surprise to the Commission as it is consistent with previous analyses of operating costs at Dublin Airport conducted by it. It is regrettable that this very favourable outcome is significantly downplayed in the report

The deficiencies in the methodology and results generated from the IJ analysis are addressed in detail in Detailed Supporting Document III which is attached to this paper. In summary, the IJ report does not constitute a robust, acceptable or appropriate basis from which to compute efficiencies for the forthcoming regulatory period.

There are two further areas in which the DAA recommend the Commission revisit its assumptions, which will be addressed in the next two sections of this paper - the Commissions assumption regarding no real wage growth and the phasing of the cost efficiency as reflected by the Commission.

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4.2 Efficiency Implementation – Real Wage Growth

In its draft determination, the Commission assumes zero real wage growth over the entire five-year price control period (purportedly due to the impact of the recession), but, at the same time, the Commission assumes that, after an initial fall in GDP (and passenger growth) between 2009 and 2010, GDP and passenger numbers increase at a rate of 2% rising to 5%. The Commission's assumptions are inconsistent and inappropriate.

One of the main responsibilities of an economic regulator is to set the level of prices that the regulated company is allowed to charge in such a way as to ensure that the regulated entity can continue to finance its activities while, at the same time, protecting consumers. In so doing, the Commission must act consistently and recognise the significant obstacles facing DAA (discussed below) in achieving the zero real wage growth that the Commission has proposed. The Commission has already pointed out that if DAA does not achieve the targets it sets for operating costs, then DAA will take longer to reach acceptable ratios (paragraph 10.8). The Commission cannot set unachievable targets in the knowledge that they will have an impact on financeability and still maintain that it has fulfilled its statutory obligations.

4.2.1 The link between changes in output growth, prices and productivity

Economic theory identifies two factors as being the main determinants of output prices in an industry operating under competitive conditions: input prices and productivity improvements.[24] Both factors are affected by the economic fluctuations in demand, or the business cycle.

With regard to input prices, recessionary periods are associated with declining price levels. The level and duration of the decline in input prices is uncertain, but some economists

[24] Output prices might also be affected by changes in scale, if the industry in question has a large fixed cost component and operates under non-constant returns to scale—these issues will be discussed later.

suggest that one of the main indicators of economic recovery would be a noticeable and sustained increase in prices.[25]

Real wage growth follows a similar pattern, but tends to be sticky when it comes to reductions. This is especially true for Ireland and DAA in particular, where trades unions play a significant role in wage-setting. Much empirical research finds evidence that, for most countries, real wage growth is pro-cyclical, i.e. in periods of recession (i.e. negative GDP growth) real wage growth is negative,[26] and that in periods of GDP growth real wage growth is positive. However, in a 2009 ECB report, real wages in Ireland (unlike the UK) are found to be counter-cyclical.[27] The authors reason that this is likely to be due to institutional frameworks governing the labour market. In addition, the flexible nature of the Irish labour market may further dampen the downward pressure on real wages. For example the ESRI forecast a net outflow of workers from Ireland in 2010 of 40,000.[28]

4.2.2 Implications for the short run, i.e. during the recessionary period

The Commission's assumptions regarding the length of the current recession[29] and thus whatever is assumed for GDP (and hence passenger) growth over the period of the price control, will need to be robust and consistent with the other key assumptions on input prices and productivity growth. Such assumptions will also need to be appropriate for DAA's circumstances.
During the recession (i.e. negative output growth), DAA's output price growth is determined by the interaction of a number of opposing forces:

- Decreases in input prices would tend to depress output prices.
- Wage stickiness, the unionisation of the labour force and the long-term pay deals and compensation agreements already in place, make restructuring efforts costly and likely to be resisted by the unions, which could in turn lead to industrial action, limiting any downward pressure on input prices and decreasing productivity.
- Decreases in productivity as a result of the economic downturn and reduced demand could cause output prices to increase.
- Companies with a flexible cost base typically respond to reduced demand by reducing capacity, however, in industries with a large element of fixed costs (e.g. infrastructure companies, such as DAA), reducing capacity beyond a certain point is very difficult, especially in the short term, exacerbating the previous effect. In the case of DAA, runways, terminals and the entire relevant infrastructure still need to be retained and maintained, even if utilisation reduces. This reduction in utilisation translates to reduced productivity, and so, it is likely that the effect of the reduced scope for productivity gains will be more pronounced for infrastructure companies and DAA in particular compared to the rest of the economy.

The end net result would depend on the strength of each factor. However, the presence of large fixed costs and a unionised workforce clearly have an adverse effect on DAA's ability to reduce costs quickly in the downturn, and thus make any significant reduction in output prices difficult to sustain without causing financeability issues.

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[25] David Blanchflower, "Green shoots? Strictly for the colour blind," *Telegraph.co.uk*, June 17, 2009, http://www.telegraph.co.uk/finance/financetopics/financialcrisis/5561259/Green-shoots-Strictly-for-the-colour-blind.html
[26] Katharine G. Abraham and John C. Haltiwanger, "Real Wages and the Business Cycle," *Journal of Economic Literature* 33, no. 3 (September 1995): 1215-1264
[27] ECB (2009), 'Real Wages over the Business Cycle: OECD Evidence from the Time and Frequency Domains', http://www.ecb.int/pub/pdf/scpwps/ecbwp1003.pdf.
[28] ESRI (2009), 'Quarterly Economic Commentary', Summer 2009.
[29] It is currently assuming a return to growth from 2010

4.2.3 Appropriate approach compared to the Commission's approach and evidence on the Irish economy

It will be critical to ensure that the Commission's approach is:

- Appropriate—that is, assumptions take into account DAA-specific issues and the practical achievability of the efficiency targets.
- Consistent—that is, assumptions on input prices, GDP growth and passenger growth and productivity need to be coherent.
- Realistic – that is, assumptions take into account the uncertainty in the current economic and industry environment.

If the Commission does not approach setting price cap in this manner, then DAA will suffer financial distress.

One way to aid consistency is to undertake TFP growth analysis. This would entail examining the empirical relationship, in the Irish, UK and EU economies, between TFP growth rates, GDP growth rates and wage growth rates, and constructing a consistent set of productivity and wage growth rates based on the forecast GDP growth rate using the EU KLEMS database.

Some of the above issues were examined and discussed in our regulatory proposition document, 'Dublin Airport Operating Costs: Forecasts 2010-2014: Commentary and Back-up'. In Section 2.2 we examined TFP growth rates over the long term, and, in Section 2.2.14, we discussed the relationship between the economic cycle and productivity, as well as the stickiness of wages. We concluded:

"The results of the analysis indicate that the scope for further efficiency gains is marginal. The estimate corresponds to a long-term average scope for productivity improvement. If the current economic downturn leads to a deep and lengthy recession, it is quite likely that the scope for productivity improvements available to DAA would be significantly reduced."

In contrast, it is clear that the Commission's current proposed approach not only does not account for DAA's specific circumstances, but is also inconsistent.

The Commission's GDP and hence passenger forecasts, are more positive compared to independent forecasts and DAA's own forecasts. The Commission's assumption regarding no real wage growth over the entire period is inconsistent with the prediction of significant GDP growth after 2010 (which would tend to result in strong real wage growth).

Moreover, DAA's wage forecasts (average ■ real increase per annum) take into account the specifics of DAA's labour force, i.e. strong union representation and recent negotiations and Labour Court recommendations. The forecasts reflect the underlying employee/DAA contracts of employment which are legally binding and which DAA cannot change unilaterally. Thus, taking the combined short-term position that DAA is exposed to short-term real wage increases consistent with DAA's forecasts, and the expectation that real wage growth will pick up as the economy moves out of recession, it is clear that the Commission's assumption of zero real wage growth is unjustified.

In addition to these issues of inconsistency and failing to take DAA's specific situation into account, the Commission's reasoning for assuming zero real wage growth is flawed. The Commission's arguments on wage growth rates are summarised and rebutted below:

"In the current economic environment, with many workers taking nominal pay cuts or freezes and public-sector employees (but not those at semi-State bodies such as the DAA) having had net pay reduced significantly following the introduction of the pension levy, there does not appear to be a compelling case for allowing wage rises in excess of inflation absent any corresponding productivity gains."

However, net pay cuts do not imply real wage cuts or real wage freezes.

Also the Commissions reference to the public sector pension levy is a distraction as there was no impact as a result of this levy on the employers wage costs, in the same way as income levies introduced by the Government had no impact on employers wage bills - only on the employees take home pay. In addition, the Company continues to progress the implementation of additional or revised pension arrangements pursuant to the July 2008 Labour Relation Commission recommendations, which includes increases in employer and employee contributions. Note also that in common with Irish pension schemes generally, there is a material deficiency in the IAS Scheme as measured by the Minimum Funding Standard at 31 March 2009 and it faces a significant funding challenge.

What is also interesting is the link the Commission has introduced here between productivity gains and real wage growth. The Commission assumes FTE reductions with the aim of delivering increased productivity at Dublin Airport, therefore it should hold that the Commissions assumption of zero real wage growth falls on the Commissions own argument.

The Commission ends by noting:

"The Central Bank's latest commentary on the Irish economy reports downward pressure on nominal pay rates in the economy. This contrasts with the DAA's forecasts for real-wage growth of about 4% per annum."

Again, nominal pay cuts do not imply real wage cuts. Indeed, the CB provides the following clear example:

"Bearing this in mind and given the labour market outlook, non-agricultural wages are forecast to fall by about 3 1⁄4 per cent in 2009, although when adjusting for expected inflation, <u>this would still constitute a real increase of about 3⁄4 per cent</u>."

In summary, in the context of the Commission's own assumptions on GDP growth over the period, and the reality of existing terms and conditions of DAA's labour force it is unrealistic and unachievable to assume no real wage growth over the period and the Commission should revise this assumption in its final determination.

4.3 Operating Cost Efficiencies

As noted earlier, DAA rejects the flawed and simplistic analysis undertaken by Indecon Jacobs which concludes that the company was inefficient in 2008.

As the Commission is aware, DAA is mindful of the impact that the recent reductions in traffic have had on its costs per passenger and is currently in the process of implementing a cost recovery programme. This programme involved reviewing FTEs and costs across the DAA, to arrive at an optimum level for the company, taking into account all existing agreements, contracts etc. However, it would be naive to assume that reductions in FTE levels will be easily achieved. The main challenges are as follows:

- Economic Downturn – The achievement of FTE reductions from any semi-state or state body, which has traditionally been viewed as secure employment, will prove more difficult in times of economic downturn, when alternative employment in the private sector is not as prevalent as during times of economic boom.
- Unionisation (as referred to earlier) – the implementation of any cost reduction initiative which involves reductions to FTE's, pay, or changes to employees terms and conditions is extremely challenging in a unionised environment. A recent example was the decision on the part of DAA to postpone the payment of national wage agreement increases and the annual increment to employees pending cost recovery discussions. However, this decision ended up in the labour court following threatened industrial action, the result of which was a recommendation which included the following:-

"in return for a clear commitment by the Unions to engage positively with the Authority on means of achieving the overall cost reductions proposed, the increments at issue should now be paid.[30]"

It is clear that any move to reduce FTE numbers, freeze or implement pay cuts, or change terms and conditions will face significant challenge from employee representatives. In fact the Commissions own consultants, Indecon-Jacobs acknowledge the role of the unions in the achievement of cost efficiencies. "*some of these savings would require flexibility from the labour unions*"[31].

In its draft determination, the Commission assumes that DAA can achieve efficiency savings in a three-year period without providing for the upfront costs of redundancy payments or payments in respect of changes to contracted terms and conditions. In contrast, the Commission's own consultants recommend that the efficiency savings can be phased in over a six-year period, on the assumption that natural attrition will reduce the need for redundancy payments.

Efficiency improvements can be split between catch-up to best practice and technological improvements or frontier shift. Large inefficiencies are due to companies being significantly adrift from the efficiency frontier, and thus significant cost reductions can be achieved by such companies undertaking significant restructuring and catching up with their peers. Such restructuring involves significant upfront costs. In contrast, companies at or close to the efficiency frontier have far less potential for efficiency improvements and any cost savings are more incremental in nature. We note that the Commission's consultants Indecon/Jacobs consider DAA to be relatively efficient:

- They conclude that, "Dublin Airport could achieve modest efficiency improvements".
- They conclude that the scope for non-staff cost reductions is "relatively limited".
- They show that Dublin has the second lowest operating costs per passenger in 2008 (out of a sample of 12 airports considered).

This outcome is consistent with DAA's own evidence from indirect benchmarking, presented to the Commission as part of its regulatory proposition document. It would therefore be more appropriate for the Commission to assume a flat profile of cost reduction savings (though as discussed below, the current economic climate may actually imply a need for back loading the profile).

[30] Recommendation no. LCR19512, Labour Court, 1st May 2009
[31] Indecon/Jacobs, *"Bottom-Up Efficiency Assessment of DAA/Dublin Airport OPEX"*,Pg52

4.3.1 Regulatory Precedent

Regulatory precedent suggests that most regulators assume a flat profile for efficiency targets. Exceptions do exist, although they tend to relate to companies that are deemed to be extremely inefficient, and regulators believe that substantial catch-up can either be achieved relatively quickly, with appropriate allowances for restructuring costs, or back loaded to provide enough time for the companies to restructure. Thus, all examples of front loading of efficiency tends to have a specific reason and for very inefficient companies. For example:

- WIC, in SRC02, back loaded Scottish Water's operating efficiency targets and provided £200m of additional expenditure upfront, known as 'spend to save', as Scottish Water was deemed to be significantly inefficient (almost 40%).
- In its initial proposals for transmission and distribution, in 2002, Ofreg considered Northern Ireland Electricity to be significantly inefficient (around 30%) and front loaded the profile of these cost reduction targets while providing for redundancy payments (though Ofreg subsequently altered the regime to an 'aligned' approach).[32]
- In the 2003 Interim Review of Track Access Charges by Network Rail, ORR front loaded the cost saving targets for Network Rail over the period 2002-07. Again, Network Rail was deemed to be significantly inefficient (at around 34%). ORR concluded that significant catch-up was feasible and, in particular, that the majority of maintenance and renewals contracts were due to expire within the first three years of the price control period and that many of the early savings could be delivered by simply eliminating waste.
- In its 2008 price cap review, ORR again considered Network Rail to be significantly inefficient. This time, ORR back loaded the profile of cost savings within the control period to allow NR time to plan and implement changes (8.33) and to increase expenditure and revenue to implement changes (8.49).

In contrast, virtually all other regulatory assumptions for cost savings follow a flat profile, especially where the regulated companies are not deemed to be highly inefficient. Such an approach should be applied to DAA given its relative efficiency, as highlighted by the Commission's own consultants.

The Commissions consultants acknowledge that both its phasing assumption and the assumption that the efficiencies can be achieved at no cost have risks associated with them when they state

"*this assumption may not be valid based on existing and future labour agreements at DAA. It should also be noted the risk that natural attrition may not always occur in the same areas cuts are required*"[33]

4.3.2 The economic climate

Front-loaded efficiency targets, as advocated by the Commission, are even more out of line with the current economic climate. As discussed in Section 3, the expected pattern of GDP

[32] In the initial proposals, Ofreg suggested a front-loaded profile of 12.5% p.a., equivalent to a 2.3% year glide path, after which, on-going efficiencies were assumed to be achieved at a rate of 1.5% p.a. Ofreg recognised that 'there may be costs associated with implementing the specific efficiencies', in particular redundancy costs, such that the catch-up efficiency targets were reduced to 9% p.a.

[33] Indecon/Jacobs, *"Bottom-Up Efficiency Assessment of DAA/Dublin Airport OPEX"*, pg42

growth is one of decline followed by return to growth; such a pattern implies reduced productivity potential followed by increased productivity potential. As such, if any profile other than flat were to be assumed, then a back-loaded profile would be most appropriate.

IJ proposed the efficiencies be phased in across a six year period. The reason given for this is as follows:
"Based on comments by DAA management and historic data on attrition rates, we assume that the phasing of the cost efficiencies do not trigger redundancy payments"[34].

In relation to IJ's conclusion that levels of historic attrition are suitable for the purposes of estimating attrition going forward, it should be noted that the period of history IJ reviewed was a period of significant growth both in the Irish Economy and for DAA. As a result the rates of attrition experienced over this time would reflect the ability for people to move from one employment to another relatively easily due to the prevalence of employment opportunities. This is not the case in an economic downturn, where rising unemployment results in a slow down in employee turnover. As a result those who are in, what is considered, secure employment will be much more reluctant to leave it.

In summary, the phasing of the implementation of the cost efficiency targets set by the Commission is unrealistic and unachievable; DAA should be remunerated for the upfront cost associated with delivering reduced staff costs if they are to be achieved in a challenging timescale. In the absence of this, the phasing should be over an achievable timeframe as recommended by the Commission's consultants.

4.4 Operating Cost Drivers

The application of costs drivers in the draft determination is at times both inappropriate, and in some cases inconsistent with the intention as stated in the draft determination.

In some cases the categorisation of operating costs, and subsequently the drivers applied for the purposes of projecting these categories, has led to unrealistic projections for several cost categories, including projections which are inconsistent with the stated intention in the draft determination. The table below details the inappropriate use of drivers to certain operating cost categories.

Cost	Projection	Issue
PRM	Projected as part of other overheads	Two issues arise here: 1) The costs are projected forward based on costs incurred in 2008 where costs of c€1.2m represented only a part year from the introduction of PRM obligations. 2) S7.15 of the draft states "The Commission has used the contract price that the DAA is paying to a contractor to provide PRM services", however in the model this cost is projected as variable in proportion to FTE's – no such provision is contained in the contract

[34] Indecon/Jacobs, *"Bottom-Up Efficiency Assessment of DAA/Dublin Airport OPEX"*, pg42

Cost	Projection	Issue
Car Park Direct Overheads	Based on Car Park FTE's	Wholly inappropriate methodology. This cost heading primarily reflects bussing costs and therefore the appropriate driver is passenger numbers and not FTE's
Head Office costs	All FTE & FTE driven costs are projected from the 2008 base, however all other costs projected using 2009 base	With the exception of the non payroll costs linked to FTE's, all other Head Office non payroll costs appear to use 2009 as base rather than 2008 (i.e. inconsistent with Dublin and FTE linked Head Office costs). S7.1 states that 2008 is the base for all opex projections
Head Office costs	Inappropriately deflated by 1%	Costs referred to above which are already in 2009 prices are being deflated by 1% CPI.
Head Office - Allocations of Mat'ls & Services	Appears to be kept level for the full period	This cost is primarily the allocation of central Retail costs to the three airports. The Commission have reflected an efficiency assumption in the calculation of the Retail Head Office costs, which appears to be reflected in the allocation to Dublin, but has not been reflected in the allocation from Head Office. The effect is that the commission are allocating more costs out than have actually been projected

4.5 Impact of T2 on operating costs

DAA welcomes the Commissions intention to allow the T2 operating tender costs as a pass through in the cap. Now that the procurement process has commenced, it is likely that the Commission will have access to more information prior to the publication of the final determination. Indeed, there is already sufficient information with the Commission to enable it to estimate the net impact on the price cap of the untendered T2 costs and the adjustments required in relation to T1 operating costs in order to inform stakeholders and provide greater clarity on the methodology the Commission is proposing with regards to projecting these costs.

There are effectively four elements, as identified by the Commission, adding up to the possible impact of T2 on the operating costs of Dublin Airport, namely:-

- T2 Tendered Services
- T2 Untendered Services
- T2 Contract Facilitations
- Adjustment to T1 operating costs

4.5.1 T2 Tendered Services

The Commissions proposal to allow the T2 tender operating costs as a pass through in the cap is welcomed by the DAA, as this is in keeping with the purpose of the tender process, which is to ensure the operating costs of T2 are the most efficient possible. The PIN for Terminal Two Facilities Management Contract was published 29th July 2009. It is expected that detail on the services to be covered under the management contract will be defined before the Commissions determination deadline.

4.5.2 T2 untendered services

Based on the service categories included in the PIN it can reasonably be concluded that those costs categorised by the Commission as being exogenous costs, will not be included in the final management contract. The Commission, in conjunction with IJ, has already acknowledged that the bulk of these exogenous costs are outside the control of DAA, and in the main has accepted DAA's projections for these costs for existing facilities. As already communicated to the Commission, the projections for the exogenous costs for T2 were based on the existing T1 costs, therefore the Commission should indicate acceptance of DAA's forecasts for these costs in T2 in the final price determination.

In the absence of further clarity on the services to be included in the management contract, the commodity categories included in the PIN could be used to inform to some extent those services which will not be covered under the tender. The financial model already submitted to the Commission includes DAA's forecast of the costs of all services in T2, therefore the Commission is in a position to make a judgement on the reasonableness of these costs in the same manner as it has for existing facilities. Again, the Commission's judgement on this aspect of T2 costs should be incorporated in the final determination so as to provide clarity to DAA, users and other stakeholders about the likely future price path once T2 is "operationally ready".

DAA recommends that the Commission engage with the company as to the most appropriate level for these costs. It is not sufficient to assume, as the Commission have indicated, that such costs are consistent with the reasonable level of opex for T1 as assessed by the Commission, without ensuring there are not drivers within T1 which differ significantly from T2, or which would be impacted by a two terminal operation.

4.5.3 T2 Contract Facilitations

The Commission acknowledges the costs to DAA of managing a contract should it be awarded to an independent operator, however the Commission should also acknowledge that were DAA to be successful in winning the tender for the operation of T2, there will be an obligation on DAA to manage the implementation and operation of the winning bid in the same manner as if it had been awarded to an independent operator.

As the specifications are developed by the advisors to the Department of Transport, the costs of facilitation are still under consideration; however they are likely to be captured under the following headings:

<u>Once Off Costs:</u>

- Costs of running the competition
- Specification Team Costs
- Consultant Fees re Tender Process
- Legal Fees re Tender Process
- Market Testing / PR Costs
- Consortium Costs
- Benchmark Costs
- Restructuring costs
- Redundancy costs
- Redesign of work practices for campus wide functions
- Set Up of Processes/Systems to facilitate 3rd Party

- Set up DAA Contract Management procedures
- Set up DAA Monitoring Regime procedures
- IT Systems Reconfiguration etc.
- Possible Changes to Building design. Potential costs of a delay to the process
- Costs of providing training & familiarisation to the independent operator if not appointed in time to avail of these prior to Practical Completion

Ongoing Costs:

- Monitoring costs
- Auditing & Compliance costs
- Contract Management costs

Other Potential Costs:

- Change Control Costs
- Costs associated with Potential Failure of SP

4.5.4 T1 Cost Adjustments

The Commission has indicated that the assessment of the appropriate adjustments to T1 costs will be carried out based on the elasticity's assumed by the Commission in the projection of the operating costs. In theory this would appear reasonable. However the Commission needs to guard against possible pitfalls in applying this approach. As previously indicated, efficiencies achievable in a single terminal operation may not be duplicated in a second terminal. Instead it may be necessary to share any efficiencies between the two facilities. The Commission's methodology must ensure appropriate provision for costs occurring in both T1 and T2. Otherwise DAA's cost base would not be fully remunerated.

For services operated by DAA, the Commission must ensure there is consistency between the remaining costs in T1, and the assumed cost in T2. Both Terminals should reflect the same assumptions regarding both fixed costs (in the form of minimum staffing levels, minimum operating costs etc) and variable (use of comparable elasticities), and any departure from such consistency must be clearly evidenced.

DAA recommends that the Commission more fully engage with DAA to better assess the expected adjustments in T1 costs on the opening of T2. DAA does not believe that the cursory nature by which the costs of existing facilities were examined by the Commission's consultants in their preliminary report provides a robust basis for concluding on this issue without further detailed engagement.

4.5.5 Requirement for Transparency re Treatment of Costs

As noted above, the Commission does not set out in the draft determination how T2 untendered costs and the adjustments in T1 operating costs will be assessed in the ultimate price cap. DAA submits that it would be contrary to regulatory certainty and the Commission's statutory objectives for the Commission to fail to address these costs in the final determination.

The principle of legal and regulatory certainty is fundamental to the efficient regulation of airport charges. Investors and market participants form expectations as to DAA's future performance based on the Commission's final determination. A lack of certainty and consistency in the final determination would lead to a perception in the market of additional regulatory risk for DAA and this could ultimately impact on the cost of capital to DAA.

Regulatory clarity is therefore vital to ensure long-term confidence in DAA's performance and enhance incentives for long-term investment in airport facilities. This, in turn, contributes towards achieving the Commission's statutory objectives of facilitating the efficient and economic development and operation of Dublin Airport and ensuring the sustainable financial viability of DAA.

All reasonably necessary expenditure must be remunerated and to the extent that the Commission has available the information to determine that costs have or will be reasonably incurred it must clarify how it will treat these costs. A failure to include in the final determination clarity on how these costs will be treated in the price cap would send a signal that the Commission is minded to arbitrarily deal with these costs at the time that T2 becomes operationally ready. It would, in addition, send a signal that the Commission is minded to treat similar costs in an inconsistent manner. For example, the financial forecasts already submitted to the Commission by DAA include DAA's forecast of all services in T2 – and therefore the Commission is in a position to deal with the reasonableness of these costs in the same way as it is for existing facilities. Accordingly, there is no reason for the Commission to treat these costs differently and a failure to address T2 untendered costs in the final determination would send an unwarranted signal to key stakeholders that the Commission might adopt a different approach to these costs at a later date.

Accordingly, in line with its statutory objectives, the Commission must ensure that DAA and other stakeholders are enabled to assess unambiguously how all known costs will (or will not) be remunerated through the price cap.

It is clear from the above that it would be inconsistent with the Commission's statutory objectives to fail to address the treatment of the T2 untendered costs and issues to do with the transfer of activities from T1 to T2 in the final determination. At the very least, in order to ensure regulatory certainty the Commission should explain its reasons for not addressing these costs. In any event, in order to comply with section 32(9) of the Aviation Regulation Act, if the Commission rejects DAA's submission on this issue, it must set out an account of its reasons.

4.6 Rolling Scheme

DAA welcomes the Commissions proposal to proceed with the implementation of a rolling incentive scheme

DAA welcomes the Commission's proposal to introduce a rolling incentive scheme in relation to operating expenditure outperformance for the next regulatory determination period. As DAA has stated on previous occasions it agrees that a rolling incentive scheme applied to operating expenditure could benefit both the regulated firm and add to overall economic efficiency. DAA set out in detail its views in regard to rolling incentive mechanisms in response to the Commission's consultation document CP4/2008.

DAA believes that from a theoretical perspective under the current price cap regime, there are stronger incentives to outperform a particular operating expenditure target at the beginning rather than the end of a regulatory period as the timing of a particular efficiency measure is highly significant in determining the level of cost savings which will accrue to the regulatory firm. DAA accepts in principle that the introduction of a rolling incentive mechanism could potentially strengthen efficiency incentives for a regulatory firm given that a rolling incentive scheme will allow for any potential benefits from a particular cost saving to be accrued evenly for a set period such as five years regardless of the timing of the measure within the regulatory determination period. It will therefore allow for the elimination of any possible distortions arising from the timing of any cost saving measures.

However DAA would like to emphasise the importance of accurate regulatory assessment of the regulated entity's operating expenditure including realistic projections of likely future efficiencies in order for such a scheme to work in practice. The regulated firm can only have an incentive to achieve greater cost efficiencies where the relevant expenditure forecasts are recognised as achievable by the company. In this instance the proposed introduction of the rolling incentive scheme will potentially be nullified by the unachievable cost efficiency targets set for the next regulatory period.

Exceptional efficiency was achieved over the last few years and the company has set ambitious cost saving targets for the period 2010-2014, therefore it will be increasingly difficult to achieve any additional gains, particularly in the current economic climate. This is reflected in the results of the benchmarking analyses provided to the Commission by DAA as part of its regulatory submission (partial productivity and total factor productivity approaches) which indicates that DAA's scope for efficiency gains is limited.

One of the principal problems associated with the CPI -X model of regulation is that it becomes increasingly difficult for the company to continue to make significant efficiency or productivity savings from one regulatory period to the next, as the regulator re-sets X at each review to incorporate efficiencies made in the previous period. In this context DAA welcomes the fact that the Commission has proposed to proceed with the implementation of a rolling incentive scheme. The principles that the Commission has set out for the operation of this scheme appear reasonable however greater clarity on the practical application, after consultation with DAA, is required.

4.7 PRM costs and remuneration

DAA believes that the cost of the provision of PRM services should be allowed as a pass through outside of the price cap

DG-TREN confirmed that charges for passengers with reduced mobility did not fall under the auspices of the Airport Charges Directive, in line with the current draft Airport Charges Directive text. We believe that this confirmation deals clearly with the issue of whether PRM charges should fall within the price cap. DAA believes that the contract price for the provision of the PRM services, which is already separately monitored by the Commission in its role as enforcement body, should be accepted and allowed as a pass through outside the price cap. The effect of including PRM costs as indicated by the Commission is to artificially inflate the price cap. This is not consistent with transparency requirements of 1107/2006. It is worth noting that the approval and reconciliation process in relation to PRMs at Dublin will be inconsistent with that at Shannon and Cork if the current proposal is implemented in the final Determination

Inclusion of inappropriate components in the price cap will also mean the DAA's aeronautical revenues will be less comparable than heretofore with other airports aeronautical revenues, and hence less easily benchmarked.

The Commission noted that it may include revenues from charges for PRM services in assessing compliance with the annual price cap. However, Article 8(5) of Regulation 1107/2006 specifically states that "the managing body of an airport shall separate the accounts of its activities relating to the assistance provided to disabled persons" and persons with reduced mobility from the current accounts of its other activities. Given this requirement for full and transparent accounts for PRM facilities, DAA believes it is inappropriate to include revenues from charges for PRM services in the price cap

Given the proposals which the Commission has made regarding price cap compliance, it is difficult to assess how the Commission would deal with any unanticipated mandatory costs in relation to PRMs which may arise in the future e.g. training or capital costs. Under PRM Regulation 1107/2006, DAA is entitled to recover all such costs but in the current proposal it is unclear how the Commission would incorporate any such adjustments.

It is the view of the DAA that in relation to PRMs, the most practical approach is for the Commission to approve the current PRM charge with a separate reconciliation in relation to PRMs which is consistent with the intent of the Regulation.

Notwithstanding the above, the Commission states that its forecast for opex for the forthcoming regulatory period presented in table 7.4, includes an allowance for the costs that DAA might incur in order to fulfil its obligations to persons with reduced mobility under Regulation EC 1107/2006. In this table, the Commission states that it has used the contract price that the DAA is paying to the contractor to provide PRM services, as its estimate of the appropriate allowance for these costs. However, our review of the regulatory model suggests that the full costs of the PRM contract have not, in fact, been included by the Commission.

5. Commercial Revenues

- DAA provided the Commission with a detailed commercial revenue plan (i.e. financial forecasts and accompanying narrative document) as part of the submission to the determination process in April 2009. The Commission has not engaged with DAA to understand the detail of the plan, review its underlying assumptions, or gain an appreciation of the local commercial environment;
- Therefore, although the Commission takes comfort from an apparent alignment between its "top down" forecast and DAA's "bottom up" submission, the impacts of decisions to disallow projects which would help grow and / or maintain commercial revenues (CIP projects) have not been accounted for;
- DAA requests that the Commission re-consider decisions taken with regards to capital investment projects where they can be proven to have a positive income impact. Fully accounting for the CIP decisions results in a variance of c. €40 million over the course of the determination period – a variance which is material in the context of funding Dublin Airport and the draft determination;
- DAA also re-iterates its strong preference for adopting a "bottom up" approach to developing agreed forecasts for commercial revenues as the only way that the complex and diverse nature of the revenues, and the rapidly changing environment, can be adequately addressed. This is aligned with the practices adopted elsewhere (e.g. the UK) as well as the previous findings of the Aviation Appeal Panel;
- While we accept that "top down" modelling has a role in testing and validating the forecast, particular issues arise with the approach taken by the Commission – including the reliability of models in forecasting through the turn in the economic cycle. We contend that the Commission has placed too much reliance on econometric modelling;
- The analysis by the Commission established a correlation between nominal revenues and other variables such as GDP and passenger numbers, but used the inferred elasticities to forecast revenue on a "real" basis (i.e. in 2009 prices). In this case we contend that the resulting forecasts may overstate expected revenues, and that either the elasticities or the resulting forecasts should be adjusted for inflation;
- The GDP forecasts used by the Commission in the draft determination appear overly optimistic when compared to recent published analyses. It is imperative that the Commission reviews its assumptions on rates of growth and the timing of any recovery in commercial revenue in line with changing macroeconomic forecasts;
- Trading conditions remain extremely challenging as both consumers and business customers reduce spending and overall economic conditions deteriorate (as demonstrated by Retail Sales indices and other economic indicators). Significant downside risks remain to DAA's commercial revenue plan, many of which are crystallising at this point;
- DAA disputes the Commission's finding with regard to the return on capital from the T1X project, and contend that it is based on a misunderstanding of the incremental income that DAA will generate from the project;
- DAA opposes the regulatory burden imposed by SI 505 on revenues derived from ATI's, especially the requirement for pre-approval by the Commission;
- The Commission has proposed that car parking could be removed from the single till. DAA welcomes this proposal as worthy of further engagement and provides some thoughts on a methodology that it believes would be appropriate for the practical implementation of this proposal.

5.1 Capital Investment Projects

The commercial revenue projections in DAA's April submission were predicated on specific assumptions relating to key capital projects, as set out in the accompanying Capital Investment Projects (CIP) submission. In the draft determination, the Commission has not allowed for – or substantially reduced the funding for – a number of capital projects which have direct impacts on forecast commercial revenues for the period. Though these proposed project disallowances / reductions have not been factored into the Commission's "top down" approach, they would materially reduce overall commercial revenue and impact the €6.20 per passenger that has been assumed by the Commission. When the CIP decisions are fully accounted for, the shortfall in commercial revenue forecasts is c. €40 million over the course of the determination period.

Though details of the specific projects are provided in Section 6, the impacts on commercial revenues are addressed here. In particular:

- Disallowing capital expenditure related to the terminal-linked Hotel / MSCP development results in c. less revenue per annum;
- The rejection of investment required to secure occupancy of vacant hanger space leads to a reduction in income from Property Rentals in the region of er annum;
- The reduction in allowable investment for Retail Refurbishment, as well as maintenance and configuration of Commercial Property will impact DAA's ability to maintain its property portfolio to the standard required in attracting and maintaining income and clients.

From the outset, therefore, the revenue generating capacity of DAA has been reduced and the proposed determination level should be re-viewed in that context. While from a "top down" perspective the Commission's forecast may appear to align well with the detailed model prepared by DAA, further analysis demonstrates that this is not the case – particularly when the impact of the CIP decisions are accounted for.

5.1.1 The Commission's Proposed CIP Decisions

A summary of the capital projects in question, along with the anticipated impact on forecast revenues in the period 2010-2014 based on internal DAA analysis, is provided in the table below.

CIP Code	Project	CAPEX Disallowed (€m)	Cumulative Impact on Revenue (€m)
CIP1.006	(Hotel) / MSCP	40.5	
CIP2.017	Hangar Maintenance	4.2	
CIP2.015 & CIP2.014	Tenant & Office Accommodation	7.5	
CIP5.013	(Disallowed) Retail Refurbishments	8.0	
CIP7.032	T1 Passenger Processing Enhancement	16.0	
Total		**76.2**	**-39.7**

Source: DAA analysis. All figures adjusted for inflation, using the CPI figures set out by the Commission in the draft determination: 0.5% (2010), 1.5% (2011), 2.0% (2012), 2.0% (2013) and 2.0% (2014).

DAA analysis indicates that the decision to disallow these investments will impact DAA's overall revenue forecasts by c. €40 million over the determination period, with the greatest impact in the later years. Of particular importance are the revenue implications of the

terminal-linked hotel / multi-storey car park development, as well as the need to support ongoing maintenance and re-configuration of properties and facilities in order to attract and retain new tenants in an extremely challenging property rental environment.

A detailed schedule showing the phased impact of the CIP decisions on Commercial Revenue Forecasts is set out below:

	2010	2011	2012	2013	2014	2010 - 2014 Total
Direct Retail [Net] (€m)						
CAR draft determination	33.0	33.0	34.0	36.0	37.0	173.0
DAA submission (April 2009)						
Less T1 Passenger Processing Enhancement [CIP7.032]						
Less (Disallowed) Retail Refurbishments [CIP5.013]						
DAA submission – with CIP impacts removed						
Concession Retail (€m)						
CAR draft determination	25.0	25.0	27.0	29.0	31.0	137.0
DAA submission – April 2009						
Less T1 Passenger Processing Enhancement [CIP7.032]						
DAA submission – with CIP impacts removed						
Car Parking (€m)						
CAR draft determination	29.0	29.0	30.0	32.0	33.0	153.0
DAA submission – April 2009						
Less (Hotel) / MSCP [CIP1.006]						
DAA submission – with CIP impacts removed						
Property Concessions (€m)						
CAR draft determination	17.0	18.0	18.0	19.0	20.0	92.0
DAA submission – April 2009						
Less (Hotel) / MSCP [CIP1.006]						
DAA submission – with CIP impacts removed						
Property Rental (€m)						
CAR draft determination	15.0	15.0	15.0	16.0	16.0	77.0
DAA submission – April 2009						
Less Hangar Maintenance [CIP2.017]						
Less Tenant [CIP2.015] & Office [CIP2.014] Accommodation						
DAA submission – with CIP impacts removed						
Property Advertising (€m)						
CAR draft determination	3.0	4.0	4.0	4.0	5.0	20.0
DAA submission – April 2009						
Less T1 Passenger Processing Enhancement [CIP7.032]						
DAA submission – with CIP impacts removed						
Other Commercial Operations (€m)						
CAR draft determination	6.0	6.0	6.0	6.0	6.0	30.0
DAA submission – April 2009						
DAA submission – with CIP impacts removed						
Total Commercial Revenues (€m)						
CAR draft determination	127.4	130.6	135.0	141.0	148.9	682.9
DAA submission – April 2009	133.0	133.0	137.2	140.9	145.5	689.6
DAA submission – with CIP impacts removed	128.5	126.1	129.0	130.9	135.0	649.5

Source: DAA analysis. CAR revenue figures per component are expressed as whole numbers, while CAR total commercial revenue figures are to one decimal place, as set out in the draft determination. DAA figures adjusted for inflation, using the CPI figures set out by CAR in the draft determination.

In summary, the impact on DAA overall revenue forecasts of adjusting for the Commission's CIP decisions equates to c. €40 million over the determination period – this equates to around €0.36 per passenger in earned revenue on average over the period.

It should be noted that the adjusted revenues (as set out in the table above) are still subject to significant risks. Indeed, the risks are greater than when DAA's revenue forecasts were presented in April due to the realisation of potential events that we noted at the time of the submission.

The assumptions underlying the revenue impacts of the other relevant CIP projects are set out below.

Terminal-linked Hotel / (MSCP) Development [€40.5m CAPEX disallowed]

The Commission has not made any allowance for capital expenditure relating to the new terminal-linked hotel / multi-storey car park development.

The impact of not proceeding with this project would be a reduction in commercial revenues arising from a loss of incremental car parking revenues from additional spaces (reflecting proactive yield management in conjunction with increased capacity) and the concession income earnable from a third party operator of a 400-bed hotel. These revenue impacts are summarised below:

	2010	2011	2012	2013	2014	Cumulative Impact on Revenue
Car Parking (€m)						
Property Concessions (€m)						
Total (€m)						

Source: DAA analysis. All figures adjusted for inflation, using the CPI figures set out by CAR.

Note that the terminal-linked hotel / multi-storey car park should be viewed as a single development, benefitting from the capital efficiencies and functional / design synergies of an integrated project.

Hangar Maintenance [€4.2m CAPEX disallowed]

As per DAA's CIP submission, capital expenditure is required for the maintenance and repair of Hangars 1, 2, 3 and 6 (all recently vacated by SR Technics) in advance of securing new tenants and generating replacement rental income.

Since the submission, DAA has made significant progress in advancing negotiations in relation to securing new tenants for the hangar buildings. However, securing tenants and the associated rental income is in all cases dependent on DAA investment in the buildings, as tenants have the reasonable precondition of receiving the property in a fit-for-purpose state.

The reduction in commercial revenue that would result as a consequence of not proceeding with this project is summarised below:

	2010	2011	2012	2013	2014	Cumulative Impact on Revenue
Property Rental (€m)						

Source: DAA analysis. All figures adjusted for inflation, using the CPI figures set out by CAR.

Tenant & Office Accommodation [€7.5m CAPEX disallowed]

In the draft determination the Commission has allowed for expenditure related to refurbishing airside ramp accommodation but not tenant and office accommodation. This expenditure is necessary both to maintain accommodation standards in an ageing premises profile and to remodel or upgrade on tenancy vacation/attract new tenants. The impact of non-refurbishment would accumulate each year as the un-renovated premises increase.

In the current economic environment many tenants are seeking to reduce the amount of space that they rent – which means that a higher level of refurbishments is needed as more new tenants are required in order to replace those departing or downsizing. Further, tenants now have a much wider choice of quality accommodation outside of Dublin Airport – which means that it is even more important that DAA invests in its stock in order to remain competitive and maintain its current rental income.

The reduction in commercial revenue that would result as a consequence of not proceeding with this project is summarised below:

	2010	2011	2012	2013	2014	Cumulative Impact on Revenue
Property Rental (€m)						

Source: DAA analysis. All figures adjusted for inflation, using the CPI figures set out by CAR.

Retail Refurbishments [€8m CAPEX disallowed]

Of DAA's proposed investment of €16.8m in retail refurbishments over the period 2010-2014, €8m has been disallowed – despite the Commission's consultants having recommended an investment of €14.6 million.

DAA are fully aware that appearance and fit-out is crucial for certain key suppliers, especially those operating in the areas of Perfume & Cosmetics. As such, it is essential that we continually update and refit the areas to attract new brands as well as continue with existing brands. Failure to do so would result both in a disincentive for key suppliers to maintain their significant presence at Dublin Airport (in terms of the breadth of products available) and in the withdrawal of dedicated customer service agents – which would result in a significant erosion of sales.

The reduction in commercial revenue that would result as a consequence of not proceeding with this project is summarised below:

	2010	2011	2012	2013	2014	Cumulative Impact on Revenue
Direct Retail (€m)						

Source: DAA analysis. All figures adjusted for inflation, using the CPI figures set out by CAR.

T1 Passenger Processing Enhancements [€16m CAPEX disallowed]

Investment in passenger processing enhancements is required in order to protect retail revenues by maximising passenger footfall along The Street (in addition to achieving operational cost savings).

It should be noted that, as per Section 6, DAA is submitting a revised T1 passenger processing project with a proposed cost of €4m. This will deliver reduced retail revenue than expected under the original processing project, but with a substantially reduced capital expenditure requirement.

The reduction in commercial revenue that would result as a consequence of not proceeding with the project as of the April submission is summarised below:

	2010	2011	2012	2013	2014	Cumulative Impact on Revenue
Direct Retail (€m)						
Concession Retail (€m)						
Property Advertising (€)						
Total (€m)						

Source: DAA analysis. All figures adjusted for inflation, using the CPI figures set out by CAR.

5.2 Reliance on a "Top Down" Methodology

Paragraph 8.3 of the draft determination states that "the Commission has primarily relied upon 'top down analyses". This analysis is based on econometric modelling (using macro-economic trends and time-series data) to generate a forecast for each of the various components of commercial revenues. Although the Commission states that it has adopted a balanced approach, and that the findings from the 'top down analysis' have not been applied mechanically, there has been no engagement with DAA on a review of the detailed plan and assumptions submitted. DAA contends that a reliance on a 'top down analysis', which is derived from economic and statistical models, is inappropriate for such a complex environment (with strong local / Airport-specific factors), and that a hybrid approach strongly informed by detailed plans per revenue component is the only robust method. This is consistent with previous findings of the Aviation Appeal Panel, and is also consistent with practice adopted elsewhere. By relying on the 'top down analysis' the Commission risks basing important revenue forecasts on an unreliable model which does not adequately account for consumer behaviour, the changing mix of traffic, the uncertain economic environment and the number and scale of developments within the Airport.

5.2.1 "Top Down" vs. "Bottom Up" Approach

DAA accepts that the use of macro-economic data and economic models should play a role in forecasting future revenues – primarily when applied to testing the outputs from the detailed "bottom up" planning and forecasting process, and in testing assumptions used therein.

In its April submission, DAA provided forecasts for commercial revenues based on a robust and reasonable planning approach whereby assumptions were developed and documented as inputs to a "bottom up" analysis for each of the components of commercial revenue, considering the specific drivers and market trends affecting each. This approach allowed specific factors to be taken into account in developing the plan – such as capacity, capital expenditure, mix of revenues, the distinction between Business-to-Consumer and Business-to-Business trends, new entrants, potential time-lags due to contracts, and strategies and policies for the various revenue components.

It also provided for the inclusion of revenues associated with new capital projects. A key issue with the "top down" approach is that it fails to allow for, or segregate the impact of capital investments. Thus, when the Commission disallows a number of investment projects in its draft determination, no allowance is made in the "top down" model for the impact on projected revenues as explained above. This has resulted in a sizeable differential between the DAA forecast revenues for 2010-2014.

5.2.2 Previous Finding of the Aviation Appeal Panel

The Commission's reliance on a "top down" approach runs contrary to the findings of the Aviation Appeal Panel in relation to the last determination period. As set out by the Panel, the common argument of principle made by DAA in relation to the Commission's assessment of commercial revenues for the 2005 determination was that the Commission had consistently ignored or set aside relevant evidence in favour of a simpler, selective and ad hoc approach to assessment. The following Panel findings are particularly relevant in this regard[35]:

> *The Panel considers that the Commission has estimated the growth in revenues from property and, in particular, car parking charges in a somewhat simplistic and mechanistic manner without regard to specific factors such as the timing of rent reviews (a legal matter) and limiting factors in relation to the potential for growing the car parking income stream.* [Section 6.6.5]
>
> *The Commission, the Panel feels, has overemphasised the link between commercial revenues and passenger growth. We do not doubt that there is likely to be a link between revenues and passenger growth, but, by focusing so heavily on this particular factor, the effect is that the projections are based upon an approach that systematically ignores other relevant factors and evidence.* [Section 6.6.6]
>
> *The Panel has considered whether the approach taken by the Commission might be justified on grounds of proportionality: that is, can it be expected that that the extra costs of developing more sophisticated projections would be materially higher than any potential benefits? Our conclusion is that the simple approach cannot be so justified, for reasons that include:*
>
> - Commercial revenues are an important factor in airport regulation by virtue of the single till approach to regulation. A reduction in commercial revenue of €1 million will have a similar effect on allowed airport charges as a €1 million increase in projected OPEX.
> - The significance of commercial revenues at Dublin Airport is relatively high by international standards, accounting for around 70% of total revenue. A one percentage point 'error' in the forecast of commercial revenues will, therefore, have a somewhat greater percentage effect on allowed, maximum airport charges, and will have a significant effect on DAA's profitability.
> - Much of the information relevant for forecasting commercial revenues will be gathered and processed by DAA as part of its normal commercial activities. The Commission is not, therefore, necessarily faced with a major information gathering exercise of its own.
>
> *Given these points, the Panel is of the view that a more analytical and bottom-up approach to commercial revenues, based upon an assessment of a wider body of relevant information and evidence, should have been taken by the Commission.*
> *The Panel considers (for the reasons set out above) that sufficient grounds have been established to refer the Commission's decision in relation to the matters addressed in this section.* [Section 6.6.7]

Despite these findings, the Commission appears to have adopted a similar approach for the 2010 determination. In conducting the analysis internally, the Commission's assessment has been carried out in an entirely "desk-top" manner with no substantive interaction with DAA on the issues arising.

[35] Source: The Aviation Appeal Panel Decision, 4th April, 2006.

5.2.3 Established Practice: Hybrid Approach to Forecasting

A hybrid approach to forecasting commercial revenues (combining elements of both "bottom up" and "top down" analysis) is common practice.

For example, in the price control review for Heathrow and Gatwick (2008-13), the Civil Aviation Authority (CAA)'s approach to projecting commercial revenues has been *"based on assessing overall trends in airport retail and property markets and testing BAA's growth projections against this analysis. Within this approach, judgement has been applied to adjust the projections for various airport-specific factors, such as the T5 retail offering and airline relocations at Heathrow, and the impact of security processing on retail space, passenger flows and passenger experience at both airports. As part of this, the CAA has also considered the specific risks attaching to commercial revenue forecasts in setting projections within the range of scenarios presented by its consultants and in assessing the evidence put forward by the Commission"*[36]. The Competition Commission, meanwhile, "placed more weight on 'bottom up' analysis of Heathrow's retail potential, taking explicit account of a range of airport specific factors… and less on the 'top down' view of overall retail performance and economic trends… on which the CAA's earlier projections were based"[37].

Examples such as these from the two busiest airports in the UK highlight the significant role that airport-specific factors play in the determination of commercial revenues.

5.3 Risks with the "Top-Down" Methodology

The Commission relies upon the results of econometric models and analysis to establish and test the correlation and elasticity between individual revenue components and variables such as the real growth of GDP, passenger numbers and retail sales. Though "the Commission accepts that it would be insufficient to rely solely on such information" (paragraph 8.5), the resulting elasticities are central to the forecasts established. DAA contends that any over reliance on 'top down analysis' is inappropriate. We also wish to highlight particular risks in the nature of the analysis completed and the potential for biased or unreliable results.

5.3.1 Access to Models and Methodology

The draft determination decision refers extensively to the Econometric Modelling on which the forecasts are based. Results from models are provided in Annex 2 of the paper, but there is limited commentary provided on the analysis completed, the exact nature of the models tested, or on the interpretation of the results and their significance. As a consequence the Commission's approach to this important building block lacks transparency, contrary to the requirements of the Aviation Regulation Act.

Without this information, our understanding of the modelling is based on those comments contained within the main body of the report, and on short responses received to queries submitted to the Commission. Without access to the models themselves or to an explanation of the model outputs (despite DAA's request for the Commission to supply the actual calculations for the elasticities used), we have sought to interpret and review the findings as best we can.

[36] Source: Economic Regulation of Heathrow and Gatwick Airports 2008-2013, CAA decision, 11 March 2008, pg. 83.
[37] Source: Heathrow and Gatwick Airports, CAA price control proposals, November 2007, pg. 100.

5.3.2 Econometric Modelling Completed by the Commission

From our reading of the draft determination, we understand that for each revenue component an econometric analysis has been completed. We would expect that this analysis sought to identify and test the significance of the correlation between a number of variables (e.g. Passenger Numbers, GDP growth etc.) and a dependent variable – i.e. the particular revenue component.

We would expect that the analysis completed would have taken the form of multivariate modelling and time series – i.e. that the models used allowed for a number of variables to be tested, rather than simple linear modelling of relationships, which would tend towards an overly simplistic conclusion.

Ultimately, we understand that the Commission has found that in all cases (i.e. for all revenue components) a primary linear relationship was found between either passenger numbers or real GDP growth and the revenue component.

Although it is not apparent from the contents of the draft determination, we can only assume that other macro factors that might affect nominal revenues for particular revenue components (inflation or the mix of passenger traffic, for example) were reviewed – though it is not clear if they were tested and proven to have a low or immaterial impact on passenger numbers or revenue.

While it can be intuitively acknowledged that the overall Retail Sales Index should align well with retail spending at Dublin Airport, and that in the period of the analysis retail spending has moved with GDP growth, we would contend that factors such as the savings rate and prices also have a role to play in this relationship, and that with a different economic cycle, the relationship may alter going forward.

A significant issue with many econometric models, and one which may be an issue in relation to the Commission's modelling approach, is the use of too limited a set of variables. This can increase the risk that estimated coefficients are biased[38]. The Commission doesn't demonstrate or discuss any tests completed for such bias. So while it is generally held that growth in GDP (or PAX or general retail sales) can act as drivers of an airport's commercial revenues, shortcomings in the Commission's models may mean that the estimated effect from them is unreliable.

Without an understanding of the models used, it is difficult to comment on the Annex provided. We would note that the elasticities adopted by the Commission are round numbers to a decimal place, and assume that these were the coefficients applied in testing the model.

5.3.3 Use of Nominal Revenues & the Impact of Inflation

Following requests for additional information in relation to the models, the Commission confirmed that the source data used in modelling revenue was in current (that is, nominal) prices. It can be concluded, therefore, that forecasts based on these elasticities are also nominal (i.e. should be adjusted downwards in line with Inflation were one to translate the figures to 2009 prices).

[38] *Econometric Analysis* (William Greene, 5th edition, 2005); Chapter 8 (Specification Analysis and Model Selections).

Given that nominal revenue numbers were used in the analysis, the elasticities derived would be considered to produce a nominal forecast. As the Commission has stated its forecast revenue on a "real" basis (i.e. in 2009 prices), we would argue that this may overstate the expected revenues. In line with good practice, consistency should be applied – such that if nominal figures are used on in developing the analysis, the outputs of the forecast derived should also be in nominal terms.

The impacts of using real versus nominal values in deriving a simple elasticity is illustrated in the table below[39] – and are clearly material.

Simple Inferred Elasticity to PAX (2002-2007) DAA Analysis or relative rate of growth	Current Prices / Unadjusted for Inflation	Real / Adjusted for Inflation (2002 Base)
Gross Direct Retail	1.01	0.57
Concession Retail & Other	1.90	1.32
Car Parking	0.73	0.33
Property Concessions	0.98	0.54
Property Rents & Other	0.38	0.04
Property Advertising	1.01	0.57
Total Commercial (ex. Retail)	0.78	0.38
Total Net Retail (ex Commercial)	1.29	0.81
TOTAL RETAIL & COMMERCIAL	0.99	0.55

DAA has completed an analysis of the impact that the use of a nominal-based model for forecasting real values for commercial revenues will have over the period 2010-2014. Our assessment is that this could lead to an overstatement of expected revenues of circa €25 million (in 2009 prices), based on applying the CPI rates set out by the Commission.

A potential issue arising from the use of current prices for the various revenue components is the impact inflation may have played in their growth during the period 2001-2008. In particular for Property Rental and Retail revenues, it is intuitively the case that inflation would feed through to the prices / rates for these items – and therefore should be considered as a variable when modelling the growth in the nominal revenues. If the impact of inflation was not considered during modelling it is possible that the results are biased as a result.

5.3.4 Time Periods & Adjustments

From the commentary provided in the draft determination, we understand that for certain of the individual models, particular years (at either the beginning or the end of the time series) were excluded from the model. DAA assumes that this was done on the basis that they were seen to be unrepresentative due to a particular event or circumstance. Only in the case of Car Parking is this explicitly identified (i.e. where a significant decline in prices occurred in 2008).

[39] As set out in Section 9.2, the Commission adjusts costs for inflation using the following CPI figures: 4.0%, 4.9%, 4.1% and -1.0% for the years 2006, 2007, 2008 and 2009 respectively.

Revenue Component	Driver / Variable	Notes
Direct Retail	Retail Sales Index	GDP Growth used as proxy for forecasting
Concession Retail & Other	GDP Growth	
Car Parking	PAX	2001-2007 (ex. 2008)
Property Concessions	PAX	2002-2008 (ex. 2001)
Property Rents & Other	PAX	2002-2008 (ex. 2001)
Property Advertising	PAX	Elasticity not used in producing forecast
Other	PAX	

DAA has in the past argued that particular years do have very time specific factors – the September 11th terrorist attacks and the Foot & Mouth epidemic in 2001 being good examples. Given the unprecedented dislocation in the Irish and global economies that is currently taking place, it is certainly the case that the period 2008-2012 will be unlike the period 2002-2007.

The fact that the Commission's own analysis required the manipulation of data to be included in the model illustrates the challenge contained in applying a 'top down analysis', even within the medium term.

As a result of the relatively short period over which the elasticities have been derived (in some cases just six years), the sensitivity of elasticity calculations to sharp changes in variables can be strong. Therefore, the implied elasticity of certain revenue components may move significantly depending on the time period included – which has a material implication on the forecasts derived. The fact that such variability can exist within implied elasticities presents a challenge to any over-reliance on this model.

5.3.5 Application of Elasticities derived during Period of Strong Growth

DAA also contend that, even if the Commission's findings are directionally correct, implied elasticities derived from data over a period of positive growth (broadly speaking the years 2001-2008 although exceptions occur as commented upon previously) will not be applicable in a time of negative growth – and, in particular, during the current unprecedented economic downturn.

A particular driver may be the change to behaviours of both consumers and businesses, not all directly explicable by macroeconomic factors such as GDP (and, in this instance, its link to PAX). This is certainly the case for Dublin Airport where, in addition to reduced passenger numbers, we have already witnessed different behaviours in terms of spending patterns, use of car parks etc.

At times of uncertainty, consumer and business savings rates, and / or control of discretionary spending increase rapidly, and consumption and investment – particularly in non-essential activities such as travel, advertising or discretionary retail – can fall rapidly. DAA is not able to determine how such relationships might change in the downturn, but we do contend that there is a strong possibility that extrapolations based on previous models cannot be relied upon. It is simply not a robust approach to assume that apparent previous relationships will continue to hold exactly as circumstances change so dramatically.

5.3.6 Inconsistent Application

Notwithstanding the faith demonstrated by the Commission in 'top down analysis' for forecasting revenues, it is particularly striking that the one area in which this approach is set aside is in the simplified extrapolation of trends for Property Advertising. As acknowledged by the Commission, this is the one component where such an approach would have led to a reduction in the revenue targeted by DAA and where the Commission state that DAA's targets are "challenging".

This is an entirely asymmetric approach, whereby the Commission only indicates a willingness to accept "a deviation from [the] relationship" to passenger growth (paragraph 8.34) where this has the effect of increasing revenue targets and thereby reducing the resulting price cap. It is also in direct contrast with the Commission's position as regards Property Rental, where it is simply stated that the Commission "does not accept the DAA's assertion that property-rental income is independent of passenger numbers" and further that it is "not aware of any factors that suggest that property rental income should deviate from long term trends for all five years of the determination" (paragraph 8.31). Indeed, it is not apparent what steps the Commission undertook to make themselves aware of any such factors – though certainly they did not involve discussion with DAA on the matter.

5.3.7 Elasticities Used

In the past, DAA and the Commission have differed as regards assumptions about the relationship between changes in passenger volumes growth and retail / commercial revenue growth. Fundamentally, DAA continue to argue that only a "bottom up" analysis of the individual revenue components can properly identify the drivers and factors that will determine revenues.

While at an overall PAX level (and a retail spending level) links are commonly used to GDP / macro factors, the one-size-fits-all approach is simply not appropriate when applied across all revenue components. This seems to be illustrated within the Commission's own results where the R-Squared value drifts as one moves from Retail to other revenue components. This suggests certain revenue components show a lower level of "fit" to the Commission's models and DAA contends that where this is the case it is particularly inappropriate to then seek to apply the elasticity models.

While it has the distinct advantage of being straightforward, simply modelling commercial revenues to passenger numbers / GDP overstates the relationship between drivers and certain revenue components, and ignores a range of other commercial and specific market factors – particularly for those revenue components driven through a business-to-business model.

Even when a relationship between specific commercial revenue elements and passenger traffic is evident, it is often a more complex association than the Commission allows for. As DAA noted in its response to the Issues Paper, car hire revenues, for example, are primarily related to the performance of the inbound tourist segment, while Car Parking revenues are primarily related to the level of Irish originating traffic and are influenced by substitute products and competition. For illustrative purposes, a number of specific factors by revenue component which should also inform the forecasting of revenues are set out below.

- Retail
    - Retail income is strongly linked to overall passenger numbers with a strong (though not perfect) correlation between passenger growth and revenue growth, but it is also strongly linked to price effects.
    - The mix of repeat passengers is an important consideration as the more frequently people travel the less inclined they are to spend on each journey;
    - Retail revenues from long haul passengers travelling to destinations outside the EU are significantly more valuable than those generated from domestic or short haul intra-EU segments – the mix of passenger growth (or decline) is therefore material;
    - Exchange rate differentials and movements in relative rates can impact on the propensity to purchase goods on one or other ends of a return journey. In particular, movements in the Euro-Sterling rates over the past 18 months have made purchases at UK airports relatively less expensive than purchasing the same product at Dublin for passengers between Ireland and UK;
    - The change in focus within DAA from Direct Retail to Concession Retail over the past several years will also have had an impact on a relative increase in retail concessionaire income, and thus the elasticities implied;
    - We are currently seeing that an increase in the savings rate is having a significant impact.
    -
- Car Parking
    - Car Parking revenues are subject to the restrictions of planning agencies, with the specific aim of impacting upon both supply and price so as to encourage the use of other modes of transport;
    - Given increased competition and the continuing introduction of additional car park capacity to service Dublin Airport users by third parties, improved coach and bus services, taxi deregulation and increased use of mobile telephony by family and friends to arrange pick up of passengers without any need to enter the car parks, the link between passenger numbers and the car park revenues has not been linear.

- Property Rental
    - Revenue from property leases does not vary in line with passenger activity at Dublin Airport;
    - Scheduled rent reviews refer to movements in market indices over the review period. Therefore, in the medium to long term, rental indices and levels of overall occupancy are more likely to drive property rents than passenger numbers, or even wider economic performance (as expressed through GDP);
    - There are strong indications that property yields are likely to fall over the short to medium term. Additionally there has been significant increase in the number of commercial buildings in proximity to Dublin Airport. As such, we forecast property rents having regard to trends in prices achieved in the office market in Ireland, forthcoming lease review dates, and trends in occupancy rates.

As set out above, allowing for such “bottom up” considerations would bring the Commission more in line with international best practice as well as the findings of the Aviation Appeal Panel in relation to the last determination period.

5.4 Current & Emerging Risks to Commercial Revenues

DAA provided a detailed set of commercial revenue forecasts to the Commission in April as part of the determination process. This set of estimates was supported by documented assumptions as well as identified risks which could materialise and impact the revenue forecasts. Also highlighted were the difficulties and uncertainties relating to the overall commercial and retail environment given the pace of decline in the economy, the decline in business and consumer confidence, and the high rate of business failure and consolidation. Since preparing and submitting the original plan, several of these risks have materialised and the potential impact of others has intensified, impacting significantly upon commercial revenue components. At the half year point in 2009, commercial revenue estimates at Dublin Airport are tracking c. 6% behind the April submission – illustrating the ongoing challenge, and the risk that the overall decline in revenue through the cycle may be more pronounced than originally forecast.

Specific risk items identified include:

- A sustained recession beyond the original recovery timeframe;
- Further decline in passenger volumes;
- Weakness in Retail demand;
- High rate of business failures amongst key clients and concessionaires – as well as agreement, lease or contract defaults, and renegotiation;

An emerging risk that will also require close monitoring is the likelihood of swine flu becoming a pandemic in late 2009 / early 2010 and the potential impact on passenger traffic.

5.4.1 Sustained Recession beyond the Original Recovery Timeframe

DAA draw the Commission's attention to the latest economic forecasts, which indicate that recovery will be delayed until 2011[40]. In paragraph 6.7 of the draft determination, the Commission commits to monitoring macro-economic forecasts and adapting its passenger forecast should they change materially. As set out in Section 3, DAA contends that the Commission's GDP data should be updated in line with recent forecasts.

For example, DAA have recalculated commercial revenues using the GDP forecasts of the IMF (one of the few institutions to have published a forecast out to 2014) and the Commission's own model, resulting in a net reduction of c. €11m in revenues over the period. In anticipation of the final determination, it is critical that the Commission continue to monitor the latest published forecasts as they become available.

It should be noted that the Commission has apparently adopted an asymmetric approach to deflation by making a -1% deflationary adjustment for 2009 operating expenditure while applying a 0% inflationary assumption for 2009 commercial revenues. DAA contends that it

[40] The latest forecasts by the Central Bank, for example, suggest that the Irish economy is likely to contract by 8.3% in 2009 and by around 3% in 2010 – with a gradual recovery "unlikely to take hold until 2011" (2008 Annual Report, Governor's Opening Statement, 14 July 2009).

is essential that a symmetric approach to inflation is taken for both OPEX and commercial revenues.

5.4.2 Further Decline in Passenger Volumes

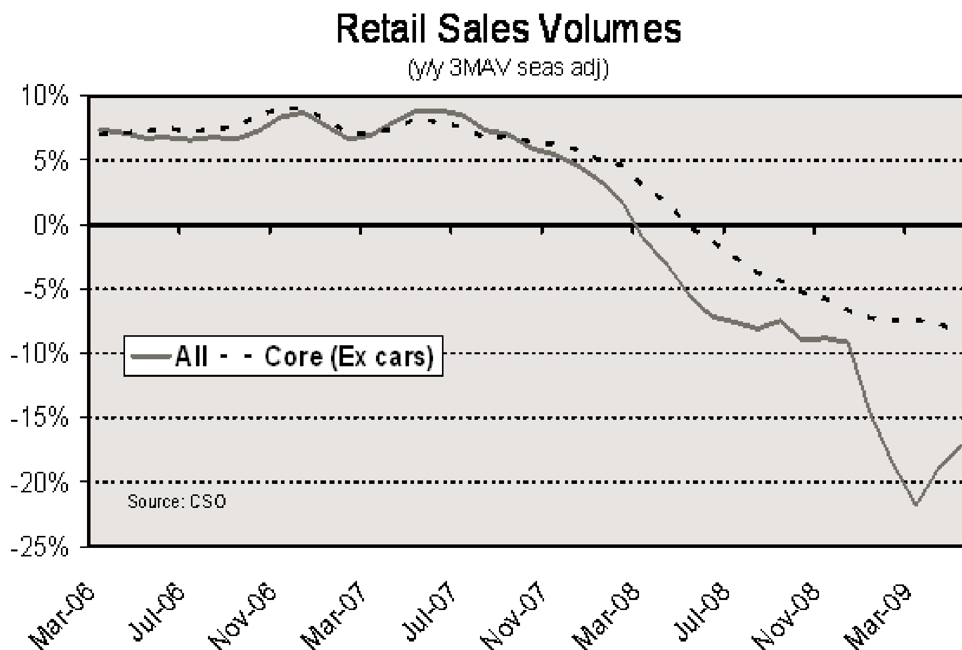
In line with the wider economic context, risks identified in the April submission have materialised to a greater extent than expected. Aer Lingus and Ryanair have both reduced their capacity from Dublin or announced their intention to do so, which will reduce traffic further this winter

Declining passenger numbers will impact particular revenue components. In the area of Car Parking, for example, less-than-anticipated holiday traffic is having a material impact on revenues from the Long Term car parks.

5.4.3 Weakness in Retail Demand

The impact of the sustained recession can also be seen in relation to retailing, with 2009 having seen the largest annual decline in core economy-wide retail sales on record.

Economy-wide retail sales figures for May (the latest month for which figures are available) show continued decline in sales volumes, continuing the trend begun in early 2008. Retail sales volumes (excluding motors) are now estimated to have fallen by 0.7% in April, with the rate of decline accelerating to 1.3% month-on-month in May. The 3 month-moving average (set out in the figure below) shows core retail sales fell by 8.4% in May, compared with a decline of 7.7% April and 7.4% in March. This measure indicates continued decline.



Source: CSO (17 July 2009)

An illustration of the impact on commercial revenues can be seen in the area of Direct Retail spend. The latest DAA analysis indicates that Duty Free average retail spend per passenger for June is 2.8% lower than that forecast in March 2009 while Duty Paid spend is 3.5% lower.

Legislation banning the display or advertising of tobacco products[41] which came into effect on 1st July has resulted in a particular additional loss of revenue in Direct Retail sales. DAA analysis suggests that the likely direct result of this legislation will be a c. 30% reduction in tobacco spends – which would equate to c. ████ drop in gross margin in a full year based on 2009 passengers.

5.4.4 Rate of Business Failures, Agreement / Lease / Contract Defaults, and Renegotiation

As anticipated by DAA, recent months have witnessed a number of public business failures or distress situations. Inevitably these impact revenues through property rental and concession incomes.

In the case of Car Hire, for example, one operator has entered in examinership ██

Overall, we continue to anticipate increasing pressure on property rental and concession income as clients seek to cut costs and ████████████ . This is in the context of rapid growth in vacancy rates for commercial property.

As a consequence of these risk items, commercial revenue estimates at Dublin Airport are currently tracking c. 6% behind the April submission – illustrating the ongoing challenge, and the risk that the overall decline in revenue through the cycle may be more pronounced than originally forecast.

5.5 T1X

The T1X project is addressed separately in the draft determination. The Commission maintains that "Given the cost of capital that the Commission has assumed, the incremental revenues identified by the DAA for T1X are less than the return on capital that the Commission would ordinarily have allowed for such a project" (paragraph 8.16). DAA do not agree with this assessment. As the actual revenue generated is at a level that generates a positive net present value, we propose that the Commission avoid complexity and treat T1X in the normal manner.

The Commission maintains that the incremental revenues identified by the DAA for T1X are less than the return on capital that the Commission would ordinarily have allowed for such a project and that consequently the project does not currently appear to be self-financing. This assessment is based on the misunderstanding that the incremental income that the DAA expects to generate from T1X in Concession Retail revenue constitutes the total anticipated incremental revenue – the €3.8m uplift as cited by the Commission was included in the April submission document in the context of setting out the assumptions underpinning the additional income in 2010 (on a full year basis) from concessionaires only. In line with DAA's most recent review of T1X business case, the project generates a nominal after-tax internal rate of return of 9.4% which is in excess of the Commission's proposed real pre-tax cost of capital of 7.0%[42]. As the IRR is higher than the Commission's proposed cost of capital the project is fully justified from a regulatory point of view.

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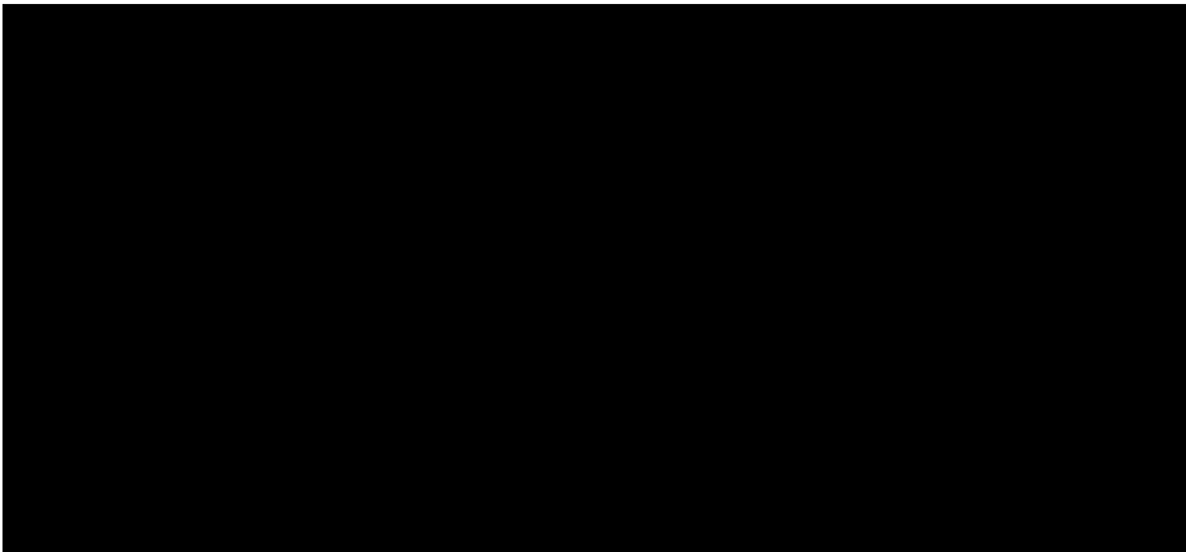
[41] Section 33A of the Public Health (Tobacco) Acts, 2002 and 2004, prohibits all advertising of tobacco product in retail premises in which tobacco products are sold – including both internal and external tobacco display and advertising signage.

[42] The nominal after tax equivalent of which would be less than 9%

As set out in the assumptions relating to Direct Retail in the April submission, given the improved facilities in T1X, DAA are targeting growth in the penetration rate for Direct Retail sales and some growth (on a neutral basis) in the value of purchases. The figure below sets out how retail sales were tracking relative to passengers before and after the opening of T1X in late April, demonstrating the T1X uplift – represented by the substantial narrowing of the gap between relative passenger traffic decline and retail sales performance[43]. (This is more clearly demonstrated in the summary chart showing the variance for the 16 weeks prior to opening of T1X and the weekly performance for the 8 weeks after opening during which time full facilities were not yet operational).

Figure 1: Pre T1X & Post T1X: % Variance in Sales & PAX (Direct Retail only)



The figure above also highlights that the retail business generally is not simply a function of passenger numbers and is impacted by the greater space and improved and more varied offering introduced by T1X.

The anticipated income from T1X by component across the determination period is set out below. These figures acknowledge the assumed reduction in income following the opening of T2.

	2010	2011	2012	2013	2014	Total 2010-2014
Direct Retail Income (€m)						
Concession Income (€m)						
Total (€m)						

Note: Figures may not add due to rounding

In summary, therefore, the Commission's assumption that T1x is generating only €3.8m p.a. is incorrect. The projected average income over 5 years is circa The project over its lifetime generates a return in excess of the cost of capital allowed by the Commission – the

[43] The presently widening gulf can be ascribed to the impact of the tobacco legislation which came into effect on 1st July

Commission should avoid complexity and treat T1x in the same manner as other allowed capex.

5.6 Access to Installation (ATI) Fees

DAA is opposed to the regulatory burden imposed by SI 505 on revenues derived from ATI's, especially the requirement for pre-approval by the Commission

The commercial revenue forecast provided by DAA to the Commission contains estimates of likely revenues arising from ATI charges. In its draft Determination, the Commission is proposing that the airport can "claw back" or "top-up" if "Access to Airport Installations" [ATI] revenues are more than or less than DAA originally forecast at the time of the last Determination. While this approach would give a degree of certainty in relation to ATI income and deal with expressed concerns regarding double counting, at the same time this increasingly interventionist approach to Regulation would further reduce the ability of the company to act in a commercial manner. Such micromanagement of Dublin Airport by the Commission is contrary to its statutory requirement to have due regard to imposing minimum restrictions on DAA.

Currently the only charge deemed to be an ATI fee at Dublin Airport is the Check-in Desk charge. DAA is substantially under-recovering the costs relating to the provision of these Check-in Desks even at the current charge levels. Airlines are now moving to alternative technologies such as SSKs and web check-in and there is increasing pressure by some airlines to discourage passengers from checking in luggage. It is therefore unclear why such a small set of facilities, which are being increasingly replaced by alternative technologies and facilities should be subject to such onerous regulation.

From a DAA perspective, check-in desks (CIDs) have traditionally been considered simple property rentals. Price flexibility is an essential commercial tool for the efficient management of Dublin Airport as it allows the company to respond to unexpected developments such as the changes in the use and nature of CIDs.

DAA believes that, given the small scale of the revenues associated with ATI (less than 1% of 2008 turnover), the level of ATI regulation is already disproportionate and unwarranted. This unique transposition of EC 96/67 in the form of SI 505 already presents a substantial regulatory burden on DAA as the level of work required to develop a proposal and get it approved is very significant.

The potential in the Commission's proposed approach for redefinition of airport charges would present unavoidable financial risks to DAA and make price cap compliance more challenging. It would also make the already challenging task of benchmarking airport charges even more difficult.

It is the DAA view that the best solution to the current difficulties with ATI charges is to amend SI No. 505 to reduce the associated regulatory burden on DAA and bring the process into line with European legislation and normal practice elsewhere, and then to allow the DAA the commercial freedom in the development of these charges. We do not believe that it is appropriate to re-define airport installations as airport charges, and if the Commission wishes to bring to bring ATI revenues within the price cap, it should do so as a separate ATI term.

However, should the Commission press on with its proposals, the Commission should clarify to DAA exactly what level of income it does actual include in the commercial revenue projections for ATI. It certainly is not clear from the draft determination, as the draft states a level of between €1.5m and €1.7m and yet based on the Commission's stated elasticities,

DAA estimate the Commission's commercial revenue forecast as including as much as €2.1m in 2014.

5.7 Car Parking: Options for Removal from Single Till

The Commission has proposed that car parking could be removed from the single till.DAA welcomes this proposal as worthy of further engagement and provides some thoughts on a methodology that it believes would be appropriate for the practical implementation of this proposal.

5.7.1 Resolving the regulatory conundrum

The Commission has acknowledged the existence of a 'regulatory conundrum' concerning the multi-storey car park (MSCP) project: the regulator wishes to encourage DAA to undertake investments that present commercial opportunities, but nevertheless protect users from underwriting such a project where users do not agree with DAA's assessment of the associated level of projected returns. Paragraph 9.58 of the Draft Determination notes that one option to resolve this conundrum is to remove car parking revenues and costs from the regulatory till, involving a one-off RAB adjustment to compensate users for the removal of revenues that currently flow into the RAB from car parks.
In DAA's view, this approach represents a reasonable, practical approach that will directly resolve the regulatory conundrum to the ultimate benefit of users of the airport. Below, the regulatory principles that are relevant to this decision are set out. This is followed by an explanation of the steps DAA believes the Commission could take to remove car parking from the till in the manner proposed.

5.7.2 Regulatory principles and considerations

Balancing commercial incentives with user interests

Under the single till system, regulated airport charges are calculated so as to provide a reasonable rate of return on the airport's RAB, taking into account activities generated by non-aeronautical or commercial activities. A dual till separates airport activities such that the prices of aeronautical activities and commercial activities are set independently of one another. The distinction between the two types of till is not absolute, and is instead one of degree, with the difference between the two approaches relating to the point at which the boundary of the till is established. Put differently, this means that the distinction between the tills is one of defining the scope or domain of regulation.

It is important to note that some activities in the till are subject to competition, or are potentially so subject, whereas other activities in the till are price controlled. For example, car parks are not price controlled and are subject to competition from other such facilities and from other modes of transport. DAA is free to respond to this competition in setting car-parking rates, but nevertheless, car parks contribute revenues in the till that are used to offset regulated charges against aeronautical activities. The issue in this context becomes one of incentives for investment, and the reasonable sharing of rewards. This raises the possibility that certain commercial assets owned by the airport, such as car parks, could be removed from the airport's RAB, and therefore from the single till.

The principle rationale for such a removal relates to the distortion to investment decisions that is caused by regulation under a single till that is a consequence of airport users, rather than car park users, trying to affect investment decisions relating to car parks. In the

absence of the till system, and in a competitive market such as applies to car parking at the airport (given competition from other modes of access and a range of offsite facilities), it is evident that investment decisions would be made primarily with regard to the interests of car park users. Given sufficiently vigorous competition for car parks, consumers will be indifferent as to who provides car-parking services, so that there are no consequences for users from changing some or all of DAA's car parks to alternative uses.[44]

Relatedly, timing decisions are more likely to be optimal in a competitive market (such as car parking) than in a regulated setting, which is required to follow particular timetables and processes, all of which may undermine attempts to take forward-looking investment decisions to respond to ongoing market signals and market demands.

The removal of services such as car parking would also permit the Commission to focus its attention and efforts on those remaining activities that are bottlenecks and exhibit market power. In practice, it is likely that these bottleneck areas will be predominantly aeronautical activities, and not commercial, competitive services such as car parking.

5.7.3 Practical steps the Commission may take to remove car parks from the RAB

Balancing commercial incentives with user interests

The critical practical step in removing car parks from the RAB will be to assess how any separation of car park assets (whether in whole or in part) from the RAB would be implemented. It will be imperative to ensure that the car park assets' removal does not contain any provision for the subsequent claw back of future gains in the value of the asset in order to preserve the value of the incentives for commercial development. If DAA is to be truly free to pursue commercial projects at its own risk, there are no grounds for the interests of users to be a relevant consideration once assets are taken out of the RAB and the till.

It is essential that in removing the car park assets from the RAB that the Commission ensures that it does not trigger unexpected adjustments to the credit rating valuation of the airport or create any negative financeability impact. It is also important that the Commission creates the right incentives for DAA to continue to invest appropriately. In order to best achieve these objectives DAA suggests the following methodology for the removal of car parking activities from the single till.

The Commission should first establish the net book value (NBV) of the car-parking assets recorded in the airport's RAB. Given the Commission's policy to review capex on a category by category basis for inclusion in the RAB and given its policy to use projected depreciation for the purposes of rolling forward the RAB, it will not be possible going forward to identify the NBV by individual asset. The Commission will need to address this issue with regard to identifying what the actual value of the car park assets are in the RAB before removing them from the regulatory till.

The Commission should then calculate the total value of the capital costs associated with these assets based on their remaining asset lives and using an appropriate assessment of the estimated long run cost of capital. The Commission should also forecast the total commercial revenues (net of associated operating costs) that these car parks assets are likely to yield over their remaining asset lives.

[44] However, if a significant amount of car park capacity is no longer available to users, this itself would have an impact on competition and the level of charges, which raises the issue as to whether entry is feasible to overcome any detriment to users arising from reduced capacity. In a well functioning market, this removal of capacity would be addressed through entry or expansion from other incumbents.

Following these assessments, the Commission could then remove the associated future revenue estimates from its commercial revenue forecast plus make an adjustment to the RAB for the removal of the value of the car park assets. This adjustment will ensure that airport users are not penalised by the removal of single till assets in the form of increased airport charges.

DAA believes that this proposed approach will provide adequate investment incentives for the regulated entity while also safeguarding the interests of airport users. In terms of the forthcoming regulatory period, DAA suggests that given the time constraints the RAB should remain unchanged but the Commission and DAA could work together to establish the required adjustment for the removal of car park assets from the RAB for the next review.

6. Capital Costs

- DAA is opposed to the Commission's approach to depreciation, which is overly complex, and which exposes the airport to unnecessary and avoidable risks that are not associated with any discernible gain to user interests.
- DAA is disappointed that significant deductions have been made by the Commission in calculating the Opening RAB. If the Commission does not adequately remunerate the capital investments made to date, DAA will be unable to continue to provide the infrastructural development that Dublin Airport requires in the future.
- DAA welcomes the Commission's efforts to clarify its treatment of the RAB going forward, but important questions remain to be resolved.
- DAA recognised the impact of the current economic downturn in submitting its capital investment proposals for the next five years and scaled back the level of investment previously envisaged by approximately 50%. In doing so DAA has taken a prudent approach to Asset Management by keeping capital expenditure to a minimum. DAA welcomes the overall assessment of Post 2009 Capex by the Commissions consultants Booz / TPS, and their conclusion that "DAA's capex unit costs match closely our independent cost analysis", though there are some issues around individual project assessment. Of greatest concern is the Commissions subsequent acceptance of only 50% of the tranche 1 and 2 projects (€198m out of €395m)
- DAA welcomes the fact that the Commission has embraced our principle of triggers for capacity projects and that a mechanism has been found for initiating these projects once growth returns to the airport. However, again there are some issues to be addressed regarding the trigger projects
- DAA rejects the Commission's proposed cost of capital as too low. It does not appropriately reflect the increased risk for DAA in the current uncertain economic environment. The cost of debt set by CAR, which draws on the cost of A rated bonds, is also inconsistent with its assumptions on the underlying credit rating in its financeability assessment.

6.1 The Commission's Approach to Depreciation

DAA is opposed to the Commission's approach to depreciation, which is overly complex, and which exposes the airport to unnecessary and avoidable risks that are not associated with any discernible gain to user interests

There are four categories of capital cost (i.e. the return *of* and *on* capital) considered in the Commission's financial model, the most important of which relate to[45]:

- Existing assets
- T2 and related Box 1
- Post 2009 Capex

[45] It is proposed by the Commission that no allowance will be made for depreciation in connection with T1X.

There is significant variation and lack of consistency in the way the capital costs of these categories of assets are being calculated in the draft determination, viz

- Existing assets are addressed by applying cost of capital to the average net book value and calculating depreciation on a straight line basis
- Depreciation for T2 is being calculated on a unitised basis
- For post-2009 Capex, the annual average Capex is treated as a single asset in that year and the capital costs are calculated on an annuity basis.

DAA's response to the Issues Paper argued that having a multiplicity of approaches to depreciation introduces unnecessary and avoidable complexity into the regulatory process, reduces the transparency of charges for the airport's users, and does not appear to be consistent with the Commission's statutory duty to impose minimum restrictions on DAA. DAA reiterates these concerns, particularly in light of the decision to remunerate T2 and 'non-conditional' post-2009 Capex using methodologies that involve a significant degree of backloading of depreciation. DAA is concerned that the impact of these alternative approaches is to add to regulatory uncertainty and to intensify the current financeability problems facing the company.

Straight line depreciation is an established means of calculating capital charges, in both regulated and non-regulated settings, and is therefore supported by a wide body of precedent[46]. DAA is not aware of regulatory precedent to support such a variety of depreciation methodologies being applied to the same regulated entity as the Commission is proposing, with no apparent rationale as to how the multiplicity of approaches is intended to support the interests of users of the airport, or be consistent with imposing minimum restrictions on DAA.

DAA's position on the unitised approach to depreciation has been set out previously, most recently in its response to the Issues Paper. Unitisation unnecessarily increases the risk faced by the airport, and cannot necessarily be guaranteed in all circumstances to produce an airport charge that is the same for passengers across all periods of the asset's life. The Commission's decision to calculate the capital cost associated with T2 over the coming determination period in order to deliver similar levels of remuneration as was reflected in the 2007 Interim review, while is adventitious, given the current economic environment, pressure on volumes and straitened financial circumstances of different aviation stakeholders. However, the need to make such an adjustment clearly illustrates a fundamental deficiency concerning the implementation of the unitised approach.

DAA would like to reiterate the recommendation that the Commission should calculate its unitised depreciation charge for T2 on the basis of total passenger numbers rather than incremental passengers above the assumed 'comfortable level' for T1 in order to deliver its intended effect of smoothing the depreciation charge across the duration of the asset life, and would also remove the necessity to make the adjustment described above.

Notably this would also be in keeping with the 2008 Appeal Panel where it was specifically provided that, to the extent that the Commission uses a unitised method of depreciation "it should ensure that the adoption of such an approach does in fact deliver the profile expected by the Commission". The Panel also provided that the unitised approach "should be confined to projects which are clearly T2 associated projects". DAA notes that while the findings of the 2008 Appeal Panel on depreciation following the DAA Appeal were not subsequently referred to in Commission papers it submits that this does not relieve the Commission of the duty to review its approach as per the Panel's findings.

[46] The use of straight line depreciation methodologies also reduces dependence on long range volume forecasts, one of the key shortcomings of the unitised approach.

DAA refers to the list of projects previously provided to the Commission as part of the company's response to CP6/2007. These projects were incorrectly identified as being T2 associated projects for the purpose of applying unitisation to depreciation charges. In fact, the projects concerned are either unrelated to T2 or they are required to support the wider airport development programme as they relate to the provision of utilities and services, which support airside and T1 enhancements in addition to T2 and the piers. There is therefore no justification for applying a unitised depreciation charge to these highlighted projects

The Commission's financial model treats all post-2009 unconditional Capex as an annuity, the life of which is the (rounded) weighted average of the life of the different component Capex categories as defined by the Commission. The depreciation element of this annuity increases over time, while the return on capital decreases, so that the overall value of the annuity remains the same over the assumed weighted average life (by construction). DAA is concerned that apart from a brief mention in the Draft Determination of the intention to move to an annuity approach for capital costs relating to post 2009 capex and a reference to this option in the 2008 Issues paper, no meaningful discussion or consultation has taken place as to the rationale for the Commission's proposed change in methodology.

The adoption of an annuity approach presents to the following issues.

- The annuity approach results in backloading of capital costs. DAA recognises that the total capital cost remains the same over time (depreciation and return combined), but the regulated entity remains exposed to regulatory risk with respect to any changes in the remuneration of capital cost. This exposure to regulatory risk vitiates the Commissions (welcome) attempts to clarify the treatment of the RAB roll forward; its ongoing 'innovations' with respect to the treatment of capital costs do not seem consistent with other attempts to provide DAA with clarity and transparency as to its decision making.
- Treating all post-2009 unconditional annual Capex as a single asset leads to further backloading relative to a category by category approach.
- The value of the RAB is artificially inflated by this methodology also, in the short term, as the depreciation charge netted off the RAB is lower than would be expected using the straight line approach applied to existing assets.
- Treating all Capex as a weighted average annuity with a life of 26 years will lead to a cliff-edge problem at the end of this 'assets' economic life. Even though the problems posed by this treatment may not materialise in the short term, introducing them at all is not consistent with good regulatory practice.

Notwithstanding DAA's stated reservations regarding the introduction of the annuity approach to post 2009 capital costs, DAA is extremely concerned that in implementing this annuity approach, the Commission has applied an average asset life of 26 years to the allowed capital expenditure of €198 million. DAA's own initial assessment (illustrated in table below) of the asset lives associated with the projects contained under the specific categories allowed yields an average asset life of just 11 years.

	CAR Determination capital spend allowed[47]	CAR Determination Estimated Asset Lives	DAA Estimated Asset Lives
Airport Infrastructure - Airport Operations[48]	49,000,000	18	7
Airport Infrastructure - Landside Infrastructure[49]	23,000,000	22	17
Airport Infrastructure - Plant and Equipment[50]	3,300,000	10	20
Airport Infrastructure - Utilities	41,900,000	32	30
Piers and Terminals - Piers and Terminals[51]	2,350,000	20	15
Revenue Projects - Retail[52]	8,756,100	10	5
Revenue Projects - Revenue	19,200,000	35	10
Stands and Airfield - Stands and Airfield[53]	30,260,000	36	12
	177,766,100	23[54]	11

The impact of the Commission applying this higher average asset life of 26 years is to severely backload the capital costs associated with the post 2009 allowable capex with an associated short run negative impact on DAA finances.

In conclusion, DAA believes a simple, straight line depreciation approach should be applied to each Capex category reflecting the same treatment as existing assets. This approach will greatly improve the transparency of airport charges for all stakeholders, and will reduce some of the negative (and in some cases apparently unintended) consequences of the complex battery of alternatives proposed by the Commission. It is not clear to DAA whether the Commission has applied unitisation and annutization to different types of Capex on the basis of the characteristics of those Capex or some other relevant consideration, or whether this choice is arbitrary. These issues must be addressed for the final determination.

[47] The Commission did not include programme management and contingency categories in the average life calculation

[48] This category includes smaller projects such as vehicles & equipment purchase, refurbishments and other short life assets as well as IT spend which tend to have asset lives of between 3 and 7 years. While there are some items which would have a longer life, the main spend is on short life assets and this is reflected in the average asset life of 7 years

[49] While some of the assets created in this category have lives of 30 to 40 years, spend includes road and car park resurfacing projects with shorter lives of 7 to 10 years which reduce the average.

[50] The only project in this category is the replacement of CHP 2 and a CHP has an average life of 20 years

[51] This category contains 1 project for life safety system with an estimated 15 year life.

[52] DAA refurbishes its retail units on average every 5 years but it is commonly known for retail outlets outside the airport to refurbish on a shorter life cycle – The 10 year cycle proposed by CAR would not be acceptable if DAA is to maintain retail revenues.

[53] The reduced cost option on the runway overlay which was proposed by CAR will only have a life of 6 years while overlays of apron and taxiways are designed for a life of 20 years so while new apron would have a life of 40 to 50 years, the average for the list of projects proposed could not be 36 years.

[54] The Commission after assigning average lives to each category then erroneously calculated the average life as 26 years when the correct figure is 23.

6.2 Opening RAB 2010

The starting RAB in 2006 was €673.1 million. The Commission has proposed an opening RAB of €891 million for the next determination, with an additional €672 million being incorporated when T2 box 1 is met.

In its assessment of the 2006 – 2009 capital programme, the Commission has made a number of draft decisions, many of which have the effect of penalising DAA unfairly. The main decisions are summarised below:

Capital Investment	Key DAA message
Programme and Project Management (Capitalised labour)	CAR has inadvertently excluded capitalised programme and project management costs in its assessment of the 2006 – 09 reconciliation.
Section 49 levies	DAA liability is independent of Metro North commencement date.
Pier D final cost	All Pier D costs should be allowed into the RAB.
T2 associated projects	These projects are either not exclusively associated with T2 or are required to support the full Transformation programme, and should therefore be allowed into the RAB from the outset of the next price review period.
Consolidation of Airport Operations / AITT / IT budgets	CAR has adopted a sensible approach in accepting these budgets in combination as they are jointly managed.
Omitted Projects	CAR has omitted three projects from its assessment of the reconciliation which should have been incorporated.
"Other Capacity Projects"	CAR has allowed only the original CIP value of these projects, and has not considered the outturn value.

A detailed write-up of each of these areas appears in Detailed Supporting Document IV – Opening RAB Omissions. In addition, the Commission has incorporated inappropriate claw backs with regard to projects which did not progress, and T2 box 2. Projects CIP5.036 and CIP8.003, and the T2 Box 2 concept, were not part of the determination that is currently in force. Therefore to include a claw back for these projects when rolling forward of the RAB is to claw back that which was never remunerated in the first place.

6.2.1 The Commission's Proposals re Principles for Rolling Forward the RAB

RAB roll forward is a critical element of the price control settlement. If a replacement cost basis is not used to value the RAB, indexed historical cost will provide a measure of consistency with past practice. The scenarios identified by the Commission are a helpful first step in reducing the regulatory risk associated with different types of Capex, but further clarity is required.

The RAB is a critical part of any price control, as it is the basis on which the airport earns its regulated rate of return, and against which an allowance is made for capital depreciation. The effectiveness of any incentive measures, and the degree of confidence that investors may be expected to maintain in relation to the treatment of current and future costs, are fundamentally dependent on the principles used to roll forward the RAB.

The main elements considered in a roll forward of the RAB are as follows:

- The valuation basis used for past investment, and the treatment of inflation
- Depreciation
- Treatment of the changes in the quantum and value of Capex

DAA's response to the Commission's specific principles for rolling forward Dublin Airport's RAB, as set out in Annex 1 of the Draft Determination, are provided under the above headings. Specific elements of the Commission's proposals may have significant implications for DAA value, and it is important that these individual components are carefully evaluated for consistency with best regulatory practice. In this context, each area of DAA's response is considered, where appropriate, in terms of relevant regulatory precedent and other guides to best practice.

Valuation of the RAB

The Commission 'favours' an indexed historical cost (IHC) basis for valuing the RAB. Previous determinations for Dublin Airport have also reflected this valuation basis, which involves the valuation of assets on the basis of original purchase costs, less accumulated depreciation. Indexation has been used to avoid future real depreciation charges being reduced as well as to ensure that an appropriate real return is earned over the lifetime of the assets.

One of the reasons for maintaining accounts of net additions to the airport's RAB is, in part, to provide a consistent basis for assessing the level of capital charges necessary to remunerate the airport for its cost of capital. Consistent regulatory treatment of the valuation basis for rolling forward the RAB provides a transparent means for the remuneration of past investments over the period of a price control. This is an important consideration for DAA, which undertakes expensive and lumpy Capex in the face of volume uncertainty and regulatory risk.

The existing and prior use of IHC provides one rationale for its application in the forthcoming control period. However, this approach does not account for trends in input costs, technical progress or opportunity costs associated with the use of the assets in question. These deficiencies of the IHC approach are especially important in the context of long-lived assets, although its application may be more justifiable for newly acquired assets for which historical cost will not normally diverge widely from replacement cost.

As DAA has noted in previous submissions to the Commission, a replacement cost basis for valuing its regulated assets would overcome the identified disadvantages of the IHC approach, and provide a forward-looking, market driven basis on which to base future capital investment decisions. DAA recognises that this approach requires a greater element of judgement than the IHC, primarily as this judgement relates to future capital values. However, forward-looking assessments of replacement cost are an established business practice (such as those regularly conducted by, for example, chartered surveyors and other valuation professions).

Although DAA still holds that replacement cost represents the most appropriate method of valuation of the RAB, it would not be possible to carry out such an evaluation given the time frame for this determination; however DAA believes that the Commission should re examine its RAB valuation at the time of the next review period.

Depreciation

The Commission proposed that depreciation in the roll forward of the RAB will be based on a projected, instead of an actual basis, with some provision for ex post adjustments

> *'the opening RAB in the following regulatory period will simply be net of cumulative expected depreciation in the preceding period, up-rated for inflation'* [55]

There are different implications for the airport according to whether depreciation is treated on an actual or projected basis in rolling forward the RAB. These include the consideration that projected depreciation is what users actually pay for, and gives the airport some incentive to carry out non-revenue earning Capex, such as, for example, to improve service quality.

It is noted that the CAA has applied projected depreciation in recent determinations made in relation to BAA's regulated airports in the UK.

Whatever approach is used, it is important that the Commission's treatment is consistent. In particular, were actual depreciation to be applied this would require the existing RAB to be revised to ensure comparability and consistency over different review periods.

Changes in Capex

The Commission proposes to continue with the so-called 'two box' approach, which requires certain conditions to be satisfied in order to determine when specific Capex may enter the RAB. DAA has communicated its objections to this approach to the Commission on a number of previous occasions, and reiterates that the approach remains inappropriate and misguided, given that the two box approach imparts more risk to the airport than conventional approaches, particularly in light of the challenging economic environment and declining volumes now confronting the airport.

DAA's response to the 'Issues Paper (CP6/2008)' recommended that the Commission consult on a clear set of guidelines, based on regulatory best practice and relevant precedent, embodying a set of principles for rolling forward the RAB. To this end, DAA welcomes the Commission's efforts to provide stakeholders with greater clarity as to how Capex and changes to existing assets will be treated in the roll forward of the RAB in the form of the seven scenarios set out in Annex 1. DAA has comments that are both general and specific in relation to these principles. In particular, DAA welcomes the Commission's proposal to review the Capex reconciliation on the basis of project categories, rather than on the basis of individual project outturns, as this more accurately reflects the nature of investment decisions over a regulatory period. However, this does not prevent the Commission from rolling forward the RAB with actual additions by asset, subject to the adjustments identified by the Capex reconciliation process. In the absence of such an approach the Commission will be unable to proceed with its proposals for the treatment of assets no longer in use, assets transferred from the RAB, assets sold etc, as it will be unable to actually identify the asset in question, or its value within the RAB.

In general terms, while the introduction of these principles represents positive progress in improving the overall framework, it is important to recognise that the principles themselves do not constitute binding commitment to constrain the Commission as to how Capex will be treated in the scenarios considered. The Commission retains discretion to alter any or all of

[55] CP3/2009 A1.12

the proposed treatment. This is a significant consideration that is relevant to any analysis of the risks to which DAA is subject.

The scenarios do not completely clarify the treatment of different investment under different circumstances. For example, in Scenario 1 the Commission states that *'For some investments, the Commission may indicate that it will defer reconciling actual investment versus allowed Capex…'* It would be helpful if the Commission explicitly identified the principles it will adopt in determining which investments would qualify for this separate treatment. For example, if the Commission faces difficulties in reconciling actual versus allowed Capex 'because the investment spans a number of regulatory periods', the Commission could clarify its proposed regulatory treatment by explicitly identifying those projects that would fall under this category, subject to a materiality threshold. DAA suggests that such a threshold could amount to investment projects with capital costs in excess of €100m and which span two control periods. It is desirable to adopt a more flexible approach in response to small Capex projects where DAA will incur costs and carry any associated risks to the beginning of the next price review; such a situation could perhaps be addressed by making provision for the Commission to signal its proposed treatment within the control period instead of waiting for the subsequent price review.

The scenarios as drafted make numerous references to 'user requirements', and 'reasonable interests'. DAA expects that, in addition to consulting stakeholders, including the airport and its users, the Commission will seek to identify the substantive meaning of these terms through its own analysis where appropriate, in order to better understand the positions of different affected parties.

DAA has the following comments in relation to the Commission's seven scenarios.

Scenario 1
'The investment delivers the expected outputs, but at a lower cost than allowed'.

- The ambiguity over differential treatment of some unidentified types of Capex was noted above. DAA agrees that it should be allowed to retain cost savings at least until future determinations, and that claw backs are not appropriate. The Commission does not clarify the nature of the forward-looking element of the capitalised adjustment to the RAB to reflect outturn costs. Any such adjustment should ensure that DAA's incentives to secure efficiency improvements within the period are preserved, so that users will continue to benefit from DAA's ongoing efforts to manage costs while maintaining service quality.

Scenario 2
'The investment delivers the expected outputs, but at a higher cost than allowed.'

- The possibility of allowing for changing user requirements as a contributing factor to higher costs than allowed, through an adjustment to the opening RAB at the next determination), is a welcome clarification
- However, the scenario leaves unresolved the means by which DAA would demonstrate that 'users were aware that the changes would result in higher costs and that the generality of users supported the changed specification'. DAA would welcome clarity as to the meaning of this statement, in particular, the likely range of thresholds and type of evidence required of DAA by the Commission in evaluating the treatment of Capex under this scenario, and the means by which different positions held by different airlines would be resolved. In DAA's view, evidence of consultation, including the extent to which other parties offered meaningful participation in this process, would represent sufficient 'user awareness'.

- Relatedly, the possibility of allowing for increased costs not under the control of the airport is welcome, but, again, clarity as to how this would be evaluated in practice is necessary. For example, recognising the opportunity for users and DAA to comment on the extent to which additional costs are controllable, how does the Commission propose to evaluate 'mismanagement of the project'? DAA suggests that any such evaluation should be with reference to objective metrics that capture only those factors that were genuinely within the control of a reasonable and prudent management. DAA would be happy to work with the Commission to develop such metrics.

Scenario 3
'The investment is not made and consequently anticipated outputs are not delivered.'

- DAA agrees that such a claw back would be appropriate in this scenario, provided Dublin Airport's ability to deliver its overall capital programme is not impaired and that alternative investment delivering the same or alternative outputs is not only allowed in the RAB but retrospective remuneration for the associated capital costs is also permitted

Scenario 4
'The investment does not deliver the outputs envisaged at the time of the original capex allowance, but instead yields a number of other outputs.'

- DAA agrees with the proposed treatment of investment that provides 'unplanned' outputs that do or do not meet the reasonable interests of users
- While the definition of users is set out in legislation, the central issue with this scenario is that the evaluation of 'required outputs' and 'user interests' requires clarification from the Commission.
- DAA agrees that consultation should not amount to a veto by particular users or groups of users

Scenario 5
'The investment was abandoned prior to completing all the work, such that some outputs were not delivered.'

- DAA agrees with the principle of treating Capex in such a way as to ensure that DAA's incentives to make efficient investment decisions are protected.
- The cost of capital should reflect the systematic risk to which DAA is exposed; the Commission's reasoning as to why avoiding incentives for DAA to complete projects in the face of sunk costs may 'allow' the Commission to set a lower cost of capital is not apparent.

Scenarios 6 and 7 relate to changes in the value of existing assets in the RAB. As indicated above, in order for the Commission to actually implement the proposals in relating to existing assets in the RAB, the Commission need to ensure they can actually identify the value of the asset in question in the RAB, hence the need for a separate approach required to Capex category reconciliation and the roll forward of the RAB by asset. There is also an issue with identifying the actual value of any individual asset in the RAB due to the Commissions depreciation policy with regard to rolling forward the RAB.

Scenario 6
'An existing asset in the RAB becomes obsolete before the end of its assumed asset life.'

- The Commission's proposals imply that an asset could earn a return even when it is no longer functional or contributing to the outputs of the airport. The fundamental issue at the core of this proposal is the relationship between individual asset accounting lives and depreciation allowances in the RAB. For instance, should the Commission proceed with the weighted average life proposed for the post 2009 Capex, it will be the case that a significant number of projects will reach the end of their lives in reality before the weighted average life assigned to them by the Commission. This inconsistency between asset lives should not be viewed as obsolescence. In circumstances such as this DAA should not be penalised or gain where either an asset comes out of use which has a NBV of zero in Dublin Airport's fixed asset register, but still has a value in the RAB, or where the asset has no value in the RAB, but still a value in the fixed asset register of Dublin Airport. In short DAA should be remunerated for the full capital cost of all projects allowed into the RAB, no matter what depreciation treatment has been applied by the Commission

Scenario 7
'An existing asset in RAB is sold by the regulated company to a third party at a value that is different to the current/remaining value in the RAB'.

- DAA believes that further clarification is required as to how the Commission envisages scenario 7 operating in practice and what precisely is meant by 'capitalised adjustment' in this context.
- In this regard DAA believes that differential treatment should not be applied to assets sold depending on the proceeds. All disposals should be removed from the RAB based on the value in the RAB. This ensures that any loss or profit resulting from the sale is entirely at the risk of DAA, meaning users are not penalised for any losses incurred as the result of the sale of an asset, and DAA get to retain any profits from the proceeds of the sale.
- In order to minimise regulatory uncertainty where assets are to be removed from the RAB, it will be important to ensure that the adjustment to the RAB is a 'once and for all adjustment' – there should be no provision for any subsequent claw back during future regulatory reviews.

6.3 Post 2009 Capex

DAA has detailed comments and specific responses to the Commission's treatment of individual projects within CIP 2010. DAA has focuses on what it believes are the key projects in CIP 2010, and a lack of comment on specific projects does not indicate agreement with the Commission's treatment of such projects.

DAA welcomes the overall assessment of our CIP by the Commission's consultants Booz / TPS, and their conclusion that "DAA's *capex unit costs match closely our independent cost analysis*". We note that of the €697m worth of capital projects that Booz assessed, their estimated cost for this work was €688m, or within 1.3%.

However, having taken a prudent approach to our proposed CIP by reducing the overall value of the programme by 50% from that originally envisaged, DAA is disappointed that the Commission has only approved 50% of the tranche 1 and 2 projects (€198m out of €395m).

Furthermore, the Commission has taken an unbalanced and asymmetric approach when assessing the project recommendations contained in the Booz report – by always taking the lower project value where Booz has proposed one (for example Engine Testing Facility, T1 Life Safety System Upgrade, Corporate IT, Central Apron Reconstruction), while at the same time disregarding Booz's proposed increases in values for other projects (New Apron Development, North Runway Fees, Upgrade of HBS equipment, Cuckoo Culvert and Airfield Pollution Control.

6.3.1 North Runway

The Commission's proposal not to remunerate the additional investment associated with delivering the proposed 3,660m runway (it proposes to allow its assessed costs for a 3,110m runway once the trigger is reached) is inconsistent with its statutory objective to have regard, not only to current users, but also to prospective users.

The extension of the North Runway would allow for greater competition. This is clearly advantageous for potential users who could enter the market and also for passengers who would benefit from increased choice and lower prices. In light of this, the Commission should be wary when interpreting current users' views on the extension and should also assess the merits of the proposed project in the longer term. It is precisely because current users' views will often conflict with those of prospective users (who are potential competitors) that the Commission is required to facilitate the development and operation of Dublin Airport so as to meet the requirements of current and prospective users.

The Commission appears to be misinterpreting the statutory objective which refers to the interests of current AND prospective users. This provision implies that prospective users' interests be given equal weight to those of current users. However, the Commission appears to be relegating prospective users to a secondary role and, indeed, to give current users a veto over capital expansion. As noted, current users will seek to block new entry which would bring additional competition, hence the Commission should be particularly wary when assessing their views and should also ensure that it does not give greater emphasis to their interests over those of prospective users.

The Commission has indicated that it does not intend to allow funding for a longer parallel runway, on the grounds that it does not meet current user requirements. By definition however, overseas airlines who want a longer runway in order to serve destinations outside the range of the existing runway are not current users, as Dublin Airport cannot accommodate them with its present facilities.

A longer parallel runway would allow direct access to key Asian markets. This will be essential in improving Ireland's trade links and connectivity with the world. A number of airlines have indicated that they would require a longer runway to service Dublin directly from the Far East.

The Commission proposes that only those airline users who benefit from the longer runway should pay for it. This approach would deter interest from potential new entrants to the market and ignores the fact that all users (business, tourism and airlines) would benefit from increased capacity and connectivity. Given the very long lead times involved in the development of runways (and indeed other aviation facilities), the Commission must not allow itself to be dissuaded from looking to the future by the short-term focus of incumbent carriers. In summary:

- A longer runway is key to the development of Ireland's economy, driven by exports to and investment from Asian markets in particular, as well as the growth of long haul tourism.
- A longer runway will open up Dublin Airport to new services and routes to key regions, thereby increasing competition and choice for all passengers. Significant levels of indirect passenger traffic to these key regions already exists (particularly to Singapore, Bangkok and Beijing), and this serves as a leading indicator of the viability of increased competition.

6.3.2 Capex Projects

We have provided a summary response below to those project decisions where we disagree with the Commission's draft determination. These are areas that, if left unchanged, will have the greatest negative impact on the long term development of the airport, and consequently on current and prospective users.

Capital Investment	Capex Req'd €m	CAR allowed in Draft Det. €m	DAA Response
Programme and Project Management	25.0 (tranches 1 and 2)	4.5	CAR has considered only the requirement for programme management, and appears to have ignored the need for project management in order to deliver the Tranche 1 and 2 capital projects.
North Runway Construction	305.0	255.0	A 3,660m runway is part of the key infrastructure needed to drive Ireland's future economic growth and will open up Dublin Airport to new routes and services, thereby increasing competition.
North Runway House Buy-Out	8.0	nil	DAA requires an €8.0 m budget (25% of total) in the next CIP in order to commence house purchases during the 2010 – 2014 period, irrespective of whether the Runway trigger is reached in that period. A further €24.8 million will be required to complete the House Buy-Out once the North Runway project commences.
Runway Overlay	23.0	7.0	DAA reluctantly accepts CAR's determination on this project, which is to allow the short term solution for €7m. This approach will lead to a higher overall capital investment being required over the next two regulatory periods, as some

			elements of spend will be nugatory. The €7m cost estimate is provisional and dependent on the outcome of an updated Runway Condition Survey.
Taxiway Centre Lights and stop bars	6.3	nil	DAA did not have an opportunity to present this project at the final Consultation meeting due to time constraints. This project will facilitate improved airfield safety and efficiency and will rectify an existing ICAO Annex 14 non compliance and as such is an essential component of the airfield workstream in the next CIP.
Engine Testing Facility	13.8	9.5	The full budget of €13.8m is required in order to deliver this project – Booz has not included provision for a required new 13,600 m2 taxiway.
Central Apron Reconstruction	15.0	13.8	The full budget of €15 million is required to deliver this project – Booz has underestimated the cost of the AGL element of this project by 90%.
B7 Taxiway Overlay	3.0	2.8	Full €3.0 million budget is required to deliver this project – Booz has underestimated the area to be overlaid by 20%.
Engine Testing Fees	0.4	0.2	Booz/CAR have mistakenly assumed that the fees associated with specialist equipment element of this project are not required. In fact, the full €400k is required in order to progress the detail design, planning application and EIS.
T1 Passenger Processing	16.0	nil	DAA has developed a much lower cost solution for €4-5 million, albeit with a reduced level of revenue benefits.
Pier B connectivity	11.0	0	The full budget of €11 million will be required to deliver this project. The Booz estimate of €9.2m is insufficient because (1) The Booz estimate does not reflect the nature, location (and complexity of the project; (2) A significant amount of existing services will need to be diverted and this work does not appear to have been included in the Booz estimates; (3) The new structure will need to be tied into existing buildings at various points and the cost of this does not appear to have been included in the Booz estimates; (4) DAA's cost estimate is based on initial design information unlike the less exact benchmark exercise undertaken by Booz; (5) The new structure is based on a unusually high wall to floor ratio; and (6) The main passenger "tube" is elevated at a height of 6.7m, thus requiring a higher ratio of structural steel per square metre than that assumed by Booz.
T1 Life Safety Systems	5.0	2.4	The full budget of €5 million will be required in order to deliver this project. Booz has underestimated the terminal area to be upgraded by 85% and the cost of the fire compartmentalisation works by 66%.
Cargo Distribution and Hangar Maintenance	15.5	13.2	Since SRT indicated their withdrawal from the Irish market in early 2009, DAA has been working to secure replacement services essential to the airport, as well as replacement tenants for the vacated Hangars. The optimum rental scenario for the Hangars is now much clearer, albeit different to that outlined with the CIP submission in

			February.
Fuel Farm / Fuel Hydrant	28.8	17.9	The allowance approved for the fuel farm must be increased by €2.5m to include the new fuel loading facility located on the Fuel Farm, without which the project will be inoperable. In addition, the value of the Fuel Hydrant trigger project must be increased by €8.4 million in order to create a complete hydrant system from the Fuel Farm to Pier E.
Retail Refurbishments	16.8	8.8	DAA's proposed investment of €16.8 million on Retail Refurbishments is essential to achieving the retail revenues contained in the financial model. A five year refurbishment cycle is now the industry norm – the longer opening hours at DAA's retail outlets make the case for observing this practice even more compelling. The DAA average cost per square metre for Refurbishments is entirely justifiable for an airport environment, and benchmarks well against other airports.
MSCP	40.5	0	The MSCP is a commercially attractive project that will earn returns in excess of the required hurdle rate while providing strong customer service benefits including a new car park adjacent Terminal 2, a terminal linked hotel, car hire facilities and superior links to Ground Transportation.
Accommodation Projects	10.5	3.0	An adequate budget for refurbishment of commercial properties is required in order to maintain rental income in a difficult market. DAA's letable estate is circa 116,000m^2, and we are seeking a refurbishment budget for only 9% of the estate. Even at that rate of refurbishment it would take over 60 years to refurbish the entire estate – a timescale that is obviously not acceptable.

All of these key points are expanded upon and supported in Detailed Supporting Document V - 2010-2014 Capital Expenditure Exclusions.

6.4 Triggers

DAA welcomes the fact that the Commission agrees that the use of triggers is "considered a sensible regulatory approach" for capacity projects and that a mechanism has been found for initiating these projects once growth returns to the airport. However, there are still some issues which need to be addressed

The Commission's proposal that surplus stand availability for aircraft in the peak week of less than 10 should trigger capex related to the New Apron Development is consistent with DAA's view. The Commission has also adopted DAA's trigger for the fuel hydrant project i.e. annual fuel demand through Pier E equal to 35% of airport wide demand in 2008.

6.4.1 T2 trigger: Definition of T2 Ready for Operations

DAA proposed in its response to the Issues paper that "practical completion" be adopted as the definition for "T2 ready for operations" and that remuneration for T2 Box 1 would

commence at that point. DAA notes that the Commission concurs that this option would have the attraction of being a "well defined milestone". However concerns about potential time lags after practical completion have led the Commission to propose to define T2 "ready for operations" as corresponding to the date specified in the contract for the operator of T2 to commence providing services.

DAA believes that the Commission's proposal could be feasibly adopted. As is the norm, any contract to commence operations will incorporate the time required by the contractor to carry out commissioning, familiarisation, operational trialling and staff training. This preparation is an essential component of opening a new facility and is an integral part of ensuring adequate service delivery to customers - all the more critical when one considers the kind of disruption that was caused to passengers and airlines at the opening of BAA's T5. DAA should not be incentivised in any way to fast track this element of T2 operations, which is every bit as important to customers as the visible daily operations post T2-opening. The Commission should recognise this in adopting its proposed definition.

It must be remembered that the stated aim of the trigger mechanism is to provide incentives for DAA to complete the T2 project in a timely manner[56]. It is not appropriate to view triggers as a mechanism for keeping the price cap artificially and irrationally low due to random events beyond DAA's control. In this context, DAA should not be penalised for any delay in the commencement of the T2 operator providing services to due to events such as legal challenges to the tender outcome or insolvency of companies involved in the process.

DAA welcomes the Commission's decision not to link the remuneration of T2 to the delivery of the north runway. As noted by the Commission there is a danger that introducing new conditions late in the delivery of a project would reduce investment incentives and not be in keeping with the Commission's statutory duties.

6.4.2 Runway trigger

DAA has concerns about the Commission's proposals for the North Runway trigger[57]. The DAA remains of the opinion that its original triggers are the most appropriate indications to activate the runway project. They ensure that when delays begin to reach a critical level or when a significant number of hours reach capacity then runway construction can begin. The proposed triggers were highly sensitive to airline needs, since they ensured delays were minimised and that airlines could continue to grow in the optimum hours.

In contrast the Commission has proposed that the trigger for building the new runway would be when passenger numbers reach 23.5mppa in the preceding year[58] Given that constraints were clearly present in 2008 when DAA handled 23.5m passengers and that it will take 2.5 years to build the runway once work is initiated, it would be the DAA's view that returning to the 2008 level would be the maximum throughput possible before work should begin.

Construction of a runway trigger

It is worth noting that since 2002, DAA has actively worked with Airlines and the Irish Aviation Authority to maximise the efficiency of the runway operations at Dublin Airport. Efficiencies delivered have resulted in the declared runway capacity at Dublin Airport

[56] Paragraph 9.26 CP3/2009
[57] This trigger is also applied to other projects as indicated in Table 9.7 of the Commission's Draft Determination.
[58] It is at this stage unclear precisely as to the implications of the trigger. DAA is assuming that once the trigger is reached it can commence recovering costs in relation to the runway. It would be helpful if there were greater clarity around the precise implications of reaching the trigger

increasing from 44 movements in the peak hour for 2004 to 48 movements in the peak hour for 2009. This has also increased the number of slots available in the core operational day by 56. While it is recognised that the runway is almost at full capacity during the core busy hours DAA will continue to work with all the stakeholders to gain further efficiencies.

Given the current level of efficiency of the runway, it is logical that the approach to developing a runway trigger should follow a "just in time" model. DAA believes that the Commission's proposed trigger will certainly not result in the runway being built too soon. Airlines have repeatedly stated that Dublin was already reaching its limits in 2008.

> *"The most constraining bottleneck in Dublin over recent years has been the departure movement rate in the morning period."*[59]

> *"Growth opportunities at Dublin airport are severely limited by the current runway capacity constraints"*[60]

Similarly, the trigger should not be so constructed that it inappropriately delays construction of the runway for a number of years, during which time it would be very difficult for Dublin Airport to grow given the current limitations on runway infrastructure. This is DAA's key concern about the Commission's proposed trigger. While the Commission allows DAA to go directly to the airlines if it feels the runway is required sooner, DAA believes that, based on our experience of consultation on capital investment projects, this could result in a complicated and difficult process, which will not suit the needs of airline passengers or the Irish economy. It would be preferable to define a robust and reasonable trigger now so that all users can be clear on the approach going forward.

The DAA suggests that the Commission should review the following major issues when defining a trigger:

- Clarify "preceding year" for the 23.5 million passengers trigger

The Commission has suggested that the trigger should be activated when "demand in the preceding year equal to or exceeding 23.5mppa" is reached. There is ambiguity as to whether this means a calendar year or a 12 month period. DAA believes that it would be preferable to assess the trigger at month end, on a rolling 12 month basis. The trigger can be simply clarified by redefining it as any month at which "Demand in the preceding 12 months equal to or exceeding 23.5mp" is reached. This would reflect user demand more closely and would avoid the scenario where the trigger is narrowly missed at the end of a year, inadvertently delaying the construction for an additional 12 months. It also lessens the potential for game-playing by the airlines.

- Reflect changing airport profile in trigger

DAA is concerned that the changing airline profile in Dublin Airport may affect its ability to return to the 2008 levels. The graph below shows the market share of overnighting carriers[61] in May 2009 compared to May 2008. As one can see, there has been a significant increase in the market share of such carriers (82.4% in 2009 v 77.1% in 2008). This is because of the number of foreign carriers that have withdrawn services from the airport over the last year. Since these carriers were based abroad, they did not operate from Dublin in the morning peak and thus they were critical to spreading demand across the day. In a downturn, the majority of services lost are normally from foreign based carriers because they

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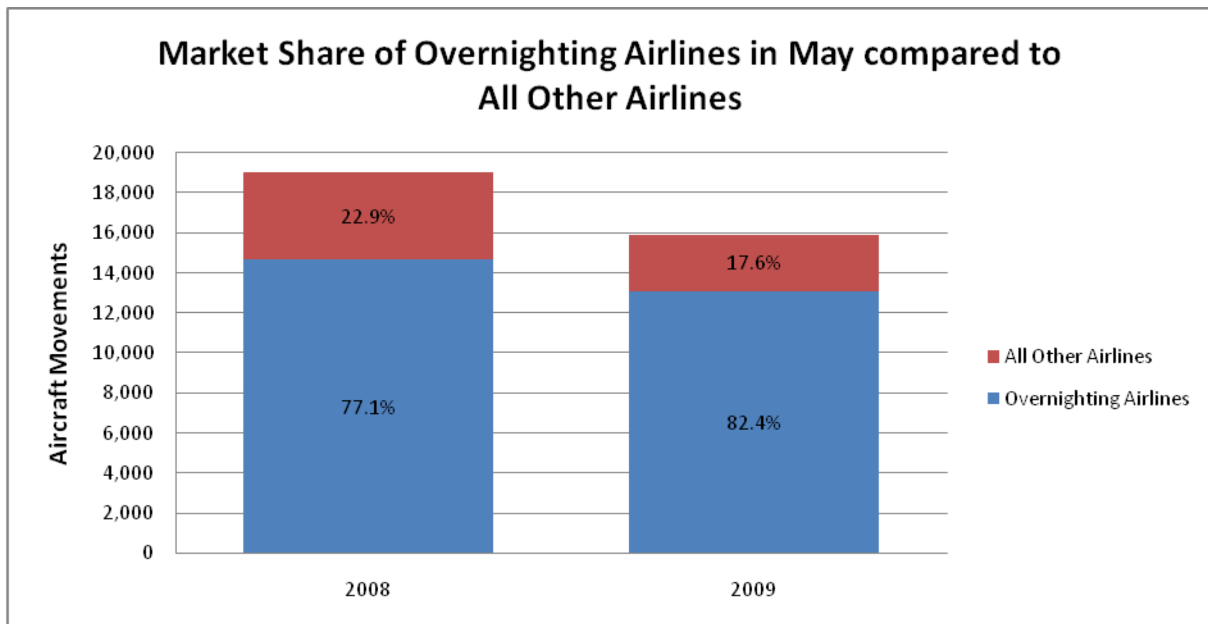
[59] Louise Congdon, DACC, "Capital Investment Needs at Dublin Airport Airport Meeting" Transcript 20090318 Pg 65

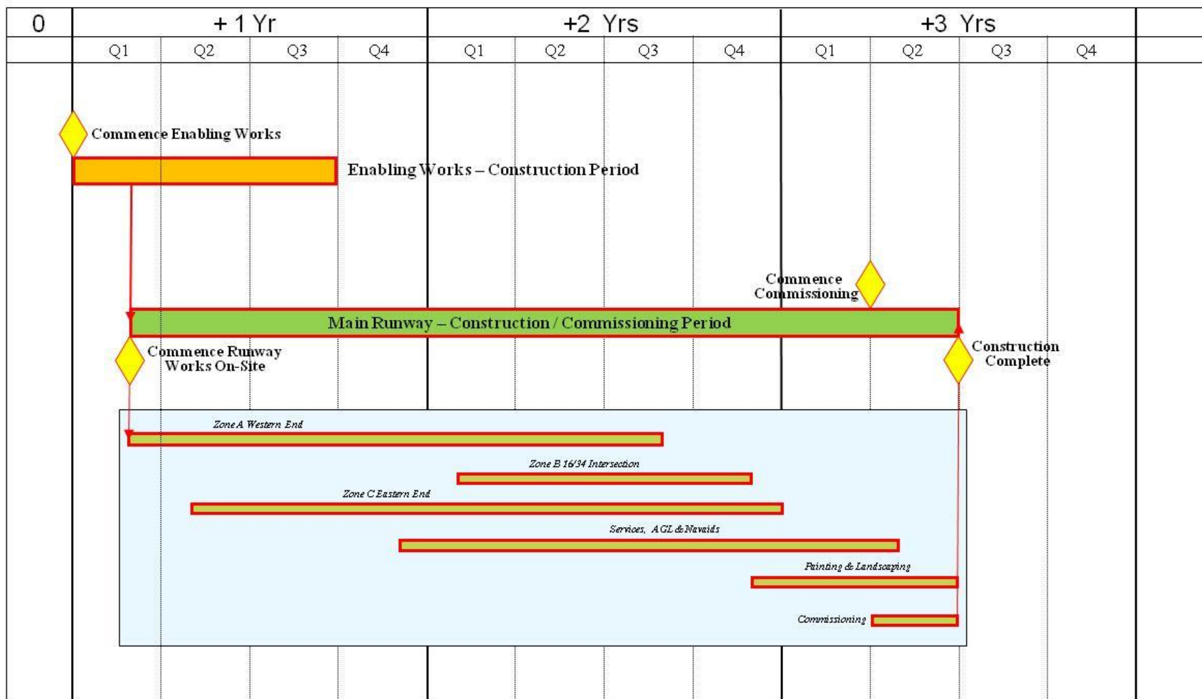
[60] Jim Callaghan, Ryanair, Letter to Mary Coveney DAA 10th Dec 2008

[61] Overnighting carriers are defined as carriers that have scheduled departures in 06:00 to 07:59 period.

do not have the same dependence on the local market. Similarly, when growth resumes, it normally comes first from overnighting (or home) carriers. These carriers can only easily grow if there are morning slots available in Dublin.



While DAA will continue to try to develop a broad range of carriers at the airport, given the economic circumstances, this is likely to be difficult over the next few years. If the non-overnighting carriers do not return to their 2008 levels, the overnighting carriers will have to make up the discrepancy before the overall annual threshold is reached. However, as noted above, the runway constraints will make it very difficult for this to happen and still allow some growth in the 2.5 years (see table below) it takes for the runway to be built. Thus there is a danger of a Catch-22 situation – that a blunt trigger will not adequately mirror the demand profile, and will in fact constrain airport growth significantly. The lack of facilities will also hinder the ability of the airport to attract new carriers into the airport.



The Additional Runway Trigger

As previously mentioned, the DAA is still of the opinion that its original triggers were the most appropriate way to activate the runway project. However, if the Commission is minded to adopt a simplified trigger of 23.5mppa, DAA would strongly suggest that a further refinement should be formulated as set out below to take into account the changing airport profile. The end result is effectively a simplification of the original trigger proposal. Delivery of the new runway should start once either trigger is achieved.

The focus should be on planned runway movements in the critical constraining period i.e. 06:00 to 07:59 local time. DAA suggests that the trigger should be activated when planned traffic levels between 06:00 to 07:59 return to levels recorded[62] in the peak month in 2008. One of the benefits of this trigger is that airline behaviour during the most critical hours would be the key determinant of when the runway is built. Given the fact that the runway will take 2.5 years to build, this will allow the airlines operating at Dublin Airport some limited ability in the intervening time to grow and use the remaining slots in these hours.

The table below displays the number of planned movements in the given period for each month of 2008. From this, we would propose the trigger be activated when planned movements return to the levels of July 2008:

	Planned Movements between 06:00 to 07:59
Jan -08	1,960
Feb-08	1,895
Mar-08	2,055
Apr-08	1,996

62 ACL records the level of planned movements for each day. This reflects the level of activity that the airport would be expected to handle on any given day.

May-08	2,154
Jun-08	2,085
Jul-08	2,191
Aug-08	2,177
Sep-08	2,146
Oct-08	2,123
Nov-08	1,915
Dec-08	1,884

Conclusion

- DAA suggests that the triggers originally proposed in the CIP are the most appropriate basis on which to activate the runway project.
- However, if the Commission is minded to adopt a simplified annual trigger of 23.5mppa, DAA recommends that
    - The trigger is calculated based on a rolling 12 month basis.
    - Additionally, DAA recommends that the Commission adopts a second complementary trigger to deal with the scenario where runway planned movements during the critical busy hours (06:00 to 07:59 local time) quickly return to peak monthly levels in (July) 2008.
- DAA recommends that the runway project is activated once either trigger in points 2.1 and 2.3 are met.
- DAA recommends that the second trigger is also applied to those projects in Table 9.7 of the Commission's Draft Determination which are currently expected to be activated by the passenger throughput trigger.

6.5 Cost of Capital

DAA rejects the Commissions inappropriate assessment of the cost of capital. Unlike in previous regulatory reviews, the Commission carried out its own analysis rather than commissioning independent experts to estimate the cost of capital. DAA believes that there are errors in the methodology which the Commission used in calculating the proposed allowed cost of capital for DAA and that the Commission did not provide adequate justification or reasoning to support the results of its cost of capital analysis.

DAA asked NERA to assess the Commission's cost of capital estimate and its report is attached as Detailed Supporting Document VI. The document links back to NERA's initial report on DAA's cost of capital which was submitted as part of the Regulatory Proposition document, and gives both a high level and detailed critique of the methodology used by the Commission to produce its estimate. The executive summary of the NERA report is set out below.

NERA Cost of Capital Assessment

Dublin Airport Authority (DAA) has commissioned NERA to review the cost of capital assumptions incorporated in the Commission for Aviation Regulation's (CAR) Draft Determination (DD) on the maximum level of airport charges for Dublin Airport to be applied at the next price control review commencing in 2010.[63] NERA's review of the DD follows on

[63]The draft decision is available at:
http://www.aviationreg.ie/_fileupload/Draft%20Determination%202010-2014%20redacted%.

from a March 2009 report NERA prepared on DAA's cost of capital (hereafter referred to as "the March 2009 report" or "the previous report").[64]

In the DD CAR propose a real pre-tax cost of capital of 7.0%, 0.4 percentage points lower than the cost of capital from the last price review in 2005 and considerably below NERA's March 2009 recommendation for DAA of 8.0-9.4%. Table 1 shows the break-down of CAR's DD alongside CAR's 2005 Final Determination and NERA's recent recommendation.

Table 1
CAR's Draft Cost of Capital (%)

	CAR Final Determination 2005	CAR Draft Determination 2009	DAA / NERA 2009 (Assuming single A Credit Rating)
Gearing	46	50	50
Real Risk-free Rate	2.6	2.5	2.8 – 4.1
Equity Risk Premium	6.0	5.0	6.0
Asset Beta	0.61	0.61	0.6 – 0.7
Real post-tax Cost of Equity*	9.2	8.7	10.0 – 12.5
Real Cost of Debt	3.7	4.1	4.6
WACC (real, pre-tax)	**7.4**	**7.0**	**8.0 – 9.4**
WACC (real, post-tax)*	***6.5***	***6.1***	***7.0 – 8.2***

Source: Maximum Level of Airport Charges for Dublin Airport Draft Determination, 18 June 2009; Note: (*) based on NERA calculation. CAR use a corporate tax rate of 12.5% for 2005 and 2009.

Table 1 highlights the key differences between CAR's DD and NERA's position:

1. Equity risk premium – CAR proposes a reduction from 6% at the last review, consistent with NERA's view, to 5% at this review despite substantial upheaval in financial markets over the intervening period;

2. Risk-free rate – CAR's DD RFR of 2.5% is similar to its 2005 position but, unlike NERA, CAR inappropriately fails to include an Irish country risk premium to compensate investors for undiversifiable Ireland-specific risks;

3. Cost of debt – CAR's recommendation of 4.1% is too low to be consistent with the investment grade credit rating it has assumed elsewhere in the DD.

Two other aspects of CAR's DD are particularly concerning:

4. CAR bases its financial viability assessment upon enabling DAA to maintain an investment grade credit rating in preference to a single A rating, which potentially inhibits DAA's access to capital during periods of market turmoil and leads to a higher cost of debt though this is not reflected in CAR's subsequent assessment, and;

5. CAR has based its estimates of the cost of capital on long run time series data and placed little weight on current evidence, which implicitly assumes that conditions will recover by the start of 2010 and that post-recovery conditions will resemble long-run historic averages contrary to all economic commentary.

[64] NERA (2009): The Cost of Capital for Dublin Airport – A Report for Dublin Airport Authority.

In this report we focus upon critiquing these five aspects of CAR's DD. We do not estimate the cost of capital in this report.

Current data cannot be ignored

The economic outlook is very uncertain, especially in Ireland. In particular, there is considerable uncertainty about how deep the recession will be and how long it will last. The central forecasts of the OECD and IMF show that GDP growth in Ireland will be negative through 2009 and 2010 and only weakly positive in 2011.[65] These forecasts are marked by wider confidence intervals than is usual with greater-than-usual weight on downside risks. Looking further ahead market commentators expect that post-recovery conditions will converge to a "new normal" characterized by higher risk premiums in both debt and equity markets.

It is clear that there is a substantial risk that macroeconomic conditions will not recover by the start of the next price control period in 2010. Further, post-recovery conditions will share much in common with current conditions and most likely will not resemble pre-crisis conditions. Taken together CAR cannot simply disregard current market evidence in its Final Determination, but must instead seek to incorporate both current and long-run time-series data into its assessment.

The Equity Risk Premium has increased, not decreased, since 2005

In its 2009 DD the CAR has used an ERP of 5%, which is 1 percentage point lower than its allowance in its 2005 determination. As the basis for its ERP estimate the CAR relies primarily upon *historical* evidence on equity returns from the Credit Suisse Global Investment Returns Sourcebook 2009. Using long-term historic data to estimate the ERP implies that past expectations are an unbiased estimate of future expectations. This assumption, however, is not appropriate at the current time since the world's financial markets are currently experiencing acute stress, which has led to a large contraction in the capital available to support investment and a significant increase in risk premiums.

There is a wide range of evidence that shows the current ERP is higher than long run historical levels. This includes:

- Forward-looking evidence from Dividend Growth Models that shows the ERP increasing consistent with declining share prices and increased perceptions of risk;
- Data from call options on the implied market volatility of the Eurostoxx 50 shows expected volatility has increased and is anticipated to remain elevated for at least the next 24 months (the longest horizon available);
- Evidence that debt spreads adjusted for liquidity premia and default risk show the ERP has increased;
- Statements from the European Central Bank that unequivocally note the increase in the ERP, and;
- Recent regulatory precedent from the UK which indicates that the arithmetic mean of historic returns data should be used to estimate the ERP and that an increase in the ERP is more justified than a decrease.

Against this background, CAR's decision on the ERP fails to properly reflect the level of volatility in the market, is out of line with recent regulatory precedent and is inappropriate. We recommend that the CAR reconsider its assessment of the ERP taking into account the updated and expanded evidence we present in this report.

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[65] See IMF Country Report 09/195 (May 2009) Ireland: 2009 Article IV Consultation-Staff Report, p. 33; OECD Economic Outlook: Ireland (June 2009)

CAR fails to include a Country Risk Premium for Ireland
CAR's risk-free rate is based solely on German government bond yields. It does not, therefore, recognize the difference in risk of investing in Ireland compared to Germany.

The additional risk of investing in Ireland should be incorporated into the risk-free rate, via an Irish country risk premium, because investors cannot fully diversify their exposure to Ireland-specific risks. This is because national equity markets are increasingly correlated as markets globalize, yet markets remain partially segmented because (among other factors) investors prefer to invest domestically rather than internationally. In particular, the increase in correlation means that diversifying the risk of one country requires taking on greater exposure to other countries, but this does not occur in practice because of home bias and other market segmentation. In recognition of this principle academics and practitioners including Damodaran (2002), Pereiro (2002), Ogier et al (2004), Koller et al (2005), and Pettit (2007) have advocated the inclusion of country risk premiums.

In this report we provide updated estimates of the Irish risk premium based on a comparison of Irish and German government bonds and CDS data. Market evidence shows a sovereign risk premium for Ireland in the range of 1.4-1.5%.

CAR should review its assessment in light of the additional theoretical explanation and updated evidence we provide.

CAR's Cost of Debt is too low
CAR concluded on a real pre-tax cost of debt of 4.1% in its Draft Determination, slightly above the mid-point of its 3.5-4.5% range, but below the 4.6% NERA recommended. CAR do not explicitly state what credit rating their cost of debt estimate is associated with, however, to be internally consistent with their financial viability assessment the cost of debt should be based on an investment grade credit rating. CAR's cost of debt is too low, however, to be consistent with a BBB rating.

In this report we cite evidence from DAA's financial advisors that shows the nominal cost of a bond issue by DAA at a BBB rating would be about 8.8% compared to about 6.8% at a single A rating. Evidence from other sources corroborates the substantial increase in the cost of debt associated with shifting from an A to a BBB rating. We also note that the CAR's conclusion – regardless of the credit rating assumed - is based on a methodology which inappropriately does not make allowance for transaction or pre-funding costs, and makes use of the UK Civil Aviation Authority's March 2009 Stansted decision which is outdated and(as Stansted is not a separately quoted airport) is not subject to any meaningful market test.

We also update our estimate of the cost of debt for DAA. Our updated estimates indicate that DAA's cost of debt is around 4.7% at an A rating, but 5.1% at a BBB rating taking into account the cost of DAA's existing debt and its refinancing and new debt requirements. Both these estimates of the cost of debt are considerably higher than CAR's.

We conclude that CAR's allowed cost of debt is too low at a BBB rating and encourage the CAR to revisit its estimate of the cost of debt incorporating the methodological changes we recommend and the updated evidence we present.

CAR's Financial Viability Test
CAR regards an investment credit rating grade – rather than the single A rating we argued for in our March 2009 report - as sufficient to enable DAA to finance Dublin Airport. However, we remain of the view that the CAR should act to enable DAA to maintain a single A credit rating, which is required to provide DAA headroom in the event of a plausible downside

scenario that might entail a credit rating downgrade: targeting an A rating allows some headroom for DAA to access the debt markets at reasonable costs under a downside scenario that leads to a downgrade to A-. However a downgrade into BBB territory might inhibit DAA's ability to raise capital as the events of late 2008 demonstrated. In this report we present updated and additional evidence that a BBB rated DAA is likely to be unable to access bond and bank debt markets as required.

In this report we also stress the need for CAR to subject its financial viability tests to plausible downside scenarios. In this report we highlight the possible impact of low or negative inflation upon DAA's financial ratios, particularly gearing and interest coverage, and DAA's credit rating. We encourage CAR to stress test its forecasts under plausible downside scenarios since DAA needs to be financially strong not only on central projections, but also in the event of unanticipated but plausible downside shocks.

7. Financial Viability

- Infrastructure and utility companies access and price debt capital on the strength of their credit rating. Therefore the impact of the draft determination on credit rating is a good place to start an analysis of the impact on "financeability".
- It is clear from the draft determination that the criteria set by Standard and Poors (S&P) for the maintenance of DAA's single A – rating will not be met and that the Commission is conscious of this fact. Therefore a downgrade to ratings in the BBB category will be an inevitable consequence of the final determination unless it is substantially changed to reflect greater regulatory support and more realistic operational and economic assumptions.
- It is likely that the downgraded rating will still carry a negative outlook reflecting the concern of rating agencies and the wider credit markets that DAA will be subject to downside volume risk in the short-medium term. Restoration of credit metrics at the end of the period is unlikely to carry any weight whatsoever with the credit rating agencies who are concerned about financial risk in the short term when passenger volumes are falling.
- A downgrade will be regarded as a failure of the regulatory regime to recognise the importance of the international credit markets to DAA and will inevitably close to DAA previously attractive pools of debt capital. Indeed we are seeing evidence of this already happening as a consequence of the draft determination. This will also be perceived as a failure of CAR to meet its objective of enabling DAA to operate and develop the airport in a sustainable and financially viable manner.

The Commission has stated that it is satisfied that DAA requires an investment grade credit rating to allow adequate access to debt funding, but not necessarily a single A credit rating. It is clear from the draft determination that the criteria set by Standard and Poors (S&P) for the maintenance of DAA's single A – rating, will not be met and that the Commission is conscious of this fact[66]. Therefore a downgrade to ratings in the BBB category will be an inevitable consequence of the final determination unless it is substantially changed.

[66]CP3/2009 p4 states *"the draft determination allows the ratio to recover to levels consistent with an investment grade credit rating"* which implies CAR are conscious that the ratio before this falls to levels consistent with a sub-investment grade credit rating

Ratings Criteria Commensurate with A- and negative outlook (current DAA rating)

Criteria	Comment
Strong business risk profile	Reflecting • Strong competitive position • 100% state owned entity • Supportive regulatory regime • Ability to defer capex from 2010 and manage costs
Intermediate financial risk profile	Reflecting • Conservative financial policies • Supportive regulatory framework that is likely to increase tariffs by at least 22% from 2010 onwards • FFO : Net debt > 15% • FFO : interest > 3.5x
Negative outlook	Reflecting • Expected decline in traffic during 2009 • Falling commercial revenues • Lack of visibility on traffic beyond 2009

Source: S&P report 20 March 2009

DAA's credit rating from Standard and Poors is currently A- with a negative outlook. The table clearly demonstrates that the current A- rating is based on an assumption that *"the supportive regulatory framework will increase tariffs by at least 22% from 2010 onward."* The implication here is that the CIP has not yet been compensated and an improvement of credit metrics through a tariff increase in 2010 is expected.

The current draft determination proposed charge of €8.35 in 2010 is an increase of only 13% from the current price cap, significantly lower than the 22% rise mentioned by Standard and Poors. Consequently, the forecast credit ratios are significantly lower than currently envisaged by Standard and Poors.

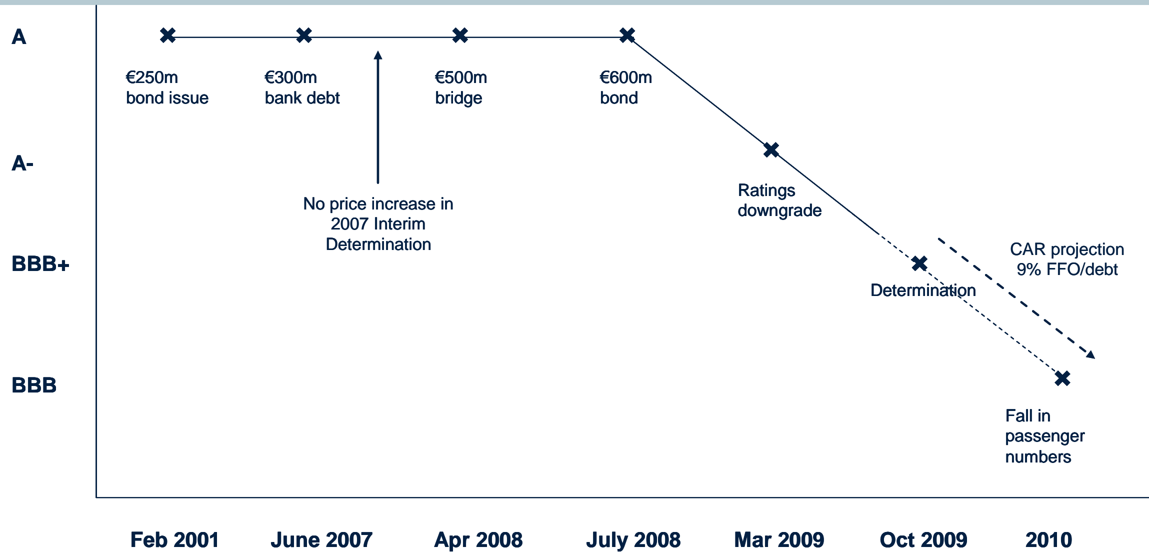
In our opinion, pointing to a restoration of credit metrics at the end of the regulatory period is unlikely to carry any weight whatsoever with the agencies who are concerned about financial risk in the short term when passenger volumes are falling.

Furthermore, S&P have clearly stated that as a policy they will be extra prudent in their rating assessments in light of current market conditions in the airports sector. [67]

7.1 Impact on refinancing of a BBB category credit rating

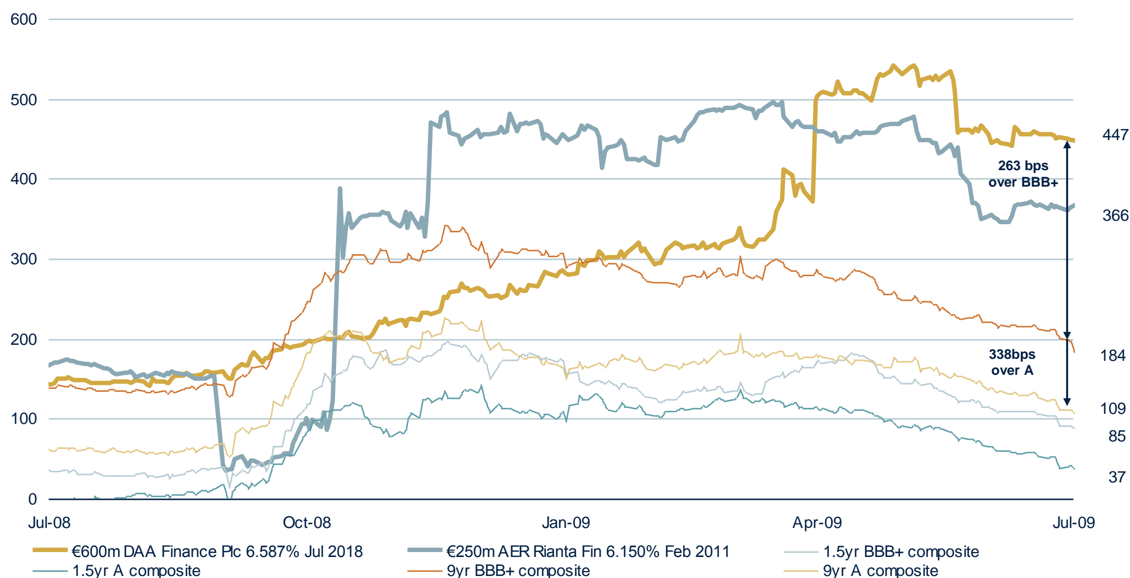
Whilst a BBB category rating is still investment grade, we see a significant impact on the availability of pools of capital available to DAA, where investors will be particularly sensitive to the continued downward trajectory of the rating and lack of regulatory support for their significant economic stake in the airport infrastructure.

[67] S&P, *Infrastructural Finance Outlook*, August 2009, P. 4



DAA issued its Eurobonds off the back of a single A rating and since then investors have seen the value of their paper diminished as a consequence of subsequent ratings downgrades. This is also evident in the significant discount with which DAA bonds trade compared to Eurozone corporates. The graph below illustrates the trading spread of DAA's two Eurobonds against an equivalent index of BBB+ and single A credits. The spread premium (as a result of the price discount) of the 2018 bond is 263bps and 338bps respectively and is a stark and indisputable manifestation of investor concerns about the credit. We believe that the Commission should recognise the continued importance of these investors as providers of debt capital to DAA and not allow the bonds to suffer a further downgrade

DAA corporate bond spreads

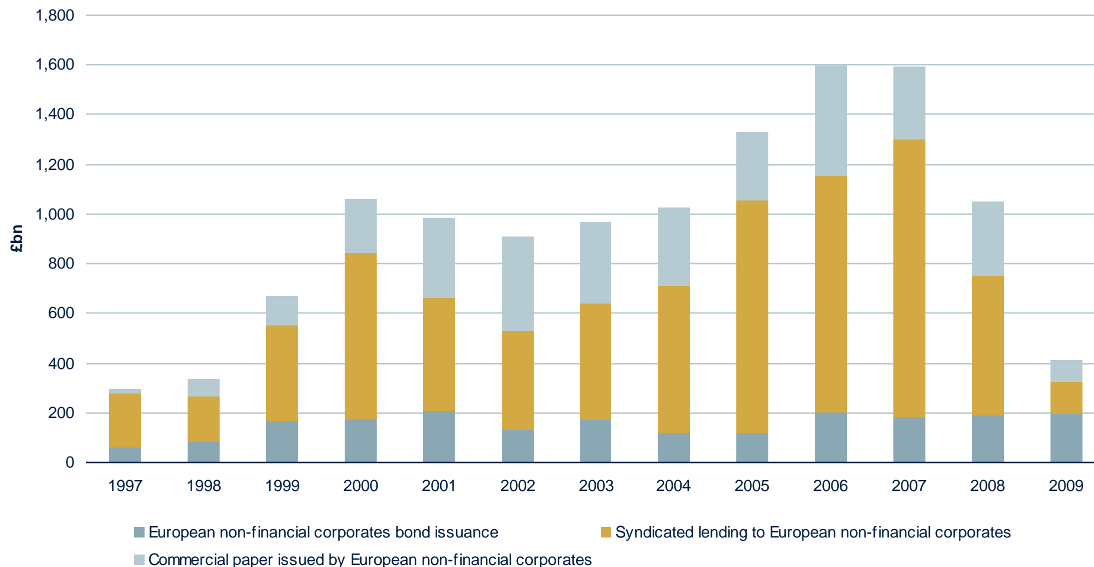


Source : Bloomberg

A downgrade to a BBB rating will disappoint and alienate bond investors, who as recently as last year invested €600m in DAA. Many bond holders have to mark their holdings to market value on a regular basis and are already shown substantial losses. These bond investors will therefore have very little appetite to increase their exposure to DAA both in terms of amount and maturity and indeed will likely be considering a reduction in their exposure given much lower expected credit ratings.

The logic of eroding confidence in the bond market is even less apparent against the backdrop of a vastly reduced and impaired bank market as can be seen in the chart below.

Historic debt issuance



Source : Dealogic

- At a BBB rating, the bank market will become more critical to DAA's funding plans, but will not be immune to the impact of ratings deterioration.

    - Banks have less risk appetite at lower ratings and in current markets charge a premium for a BBB risk as quantified in the NERA report

    - Banks will no longer offer 5 year tenor (3 years is now the "sweet spot") and as such DAA will have to refinance more frequently, incurring expensive transaction costs more regularly. Any bank financing put in place now would only add to the refinancing cliff in 2011/12 rather than mitigate it.

    - Banks are less comfortable about a borrower's ability to refinance bank lines in the bond markets at a BBB rating and will therefore price on the assumption that there are no ancillary bond fees and that their balance sheet capital is "tied up" for the medium term. The most recent bank facility of €500m negotiated by DAA at the beginning of 2008 was raised on the explicit assumption of an immediate refinancing in the bond markets. It is fair to say that without this refinancing option, this facility would not have been available from the three bank providers.

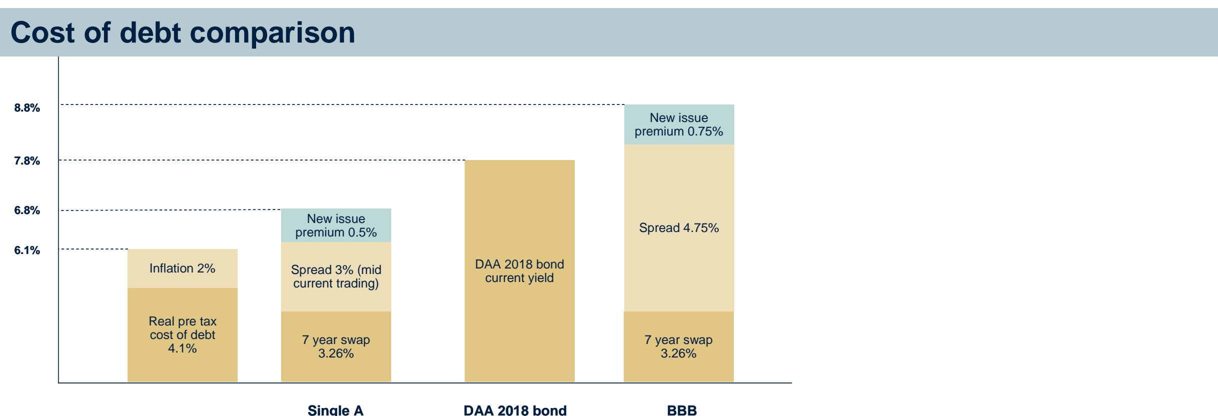
    - Banks will use their negotiating power to introduce financial covenants or ratings triggers into the credit documentation The effect of this will be to increase the default probability of DAA's credit facilities giving far less financial flexibility and headroom for the group's operations and investment plans and more critically increasing the sensitivity of DAA to a loss in passenger numbers.

- A BBB rating will move DAA towards a shorter term debt structure as DAA will not be able to access long term debt markets. This in turn creates a vicious circle as it increases DAA's refinancing risk which will feed into S&P's evaluation of the credit and put further downward pressure on ratings.

7.2 Cost of debt

The table below sets out our estimate of the cost of debt, based on prevailing market conditions, using a BBB and a single A profile and compares it to the assumption made by the Commission in its draft determination. It can be seen that whilst the Commission has made the point that a single A rating is unnecessary, this is not consistent with its own cost of debt assumptions in the report.

Cost of debt comparison



Source : DAA estimates

We have discussed the impact of the draft determination on DAA's credit rating and the implications for sources and cost of debt. We now consider this in tandem with a passenger downside scenario which has the impact of accelerating DAA's cash burn and liquidity requirements.

DAA will be loss making on a net profit basis with no ability to pay dividends or generate a return to equity. This logically indicates that there is no equity buffer for the debt and that the balance sheet is fundamentally over-geared notwithstanding the equity injection of €0.5 billion from the sales of Great Southern Hotels and ARI stakes in Birmingham and Hamburg Airports.

7.3 Conclusion

- Based on the current draft determination, it is highly likely that DAA would be downgraded to a BBB ratings category
- We believe that the cost to DAA of allowing the rating to fall to a BBB ratings category is as follows
    - A loss of investor confidence and support in the bond markets
    - Shorter term debt
    - More highly covenanted debt
    - Less incentive to borrow and invest
- The Commission should therefore carefully consider the impact of a lower credit rating on DAA's financeability that would be caused by the current draft determination

8 Other Issues

- DAA welcomes CAR's decision to abolish sub-caps as their use can restrict DAA's ability to use the structure of airport charges to maximise economic efficiency.
- DAA has highlighted significant practical and cost reasons why it is impractical to seek price cap over-collections to be refunded to airport users within 45 days of the end of that regulatory year.
- The proposal to treat under-collections in a different manner to over-collections is asymmetric and unwarranted and significantly increases the financial risk to DAA, particularly in the forthcoming period.
- It is appropriate that Dublin Airport City be excluded from the regulatory till as it has insufficient nexus to the regulated business.

8.1 Subcaps for Cargo and General Aviation

DAA welcomes the fact that the Commission has accepted the points put forward by the airport authority and the cargo community and is proposing not to implement sub-caps for general aviation and cargo as part of the next review. The ability to adjust pricing structures in response to market dynamics is an essential requirement for any business. DAA has always maintained that the application of sub caps restricts its ability to use the structure of airport charges to maximise economic efficiency.

8.2 Price Cap Compliance

DAA has consistently stated and repeats here, its commitment to comply with the price cap set by the regulator. Such compliance is in accordance with the company's principled and responsible approach to regulation.

In the first instance, it is important to note that while operating to a price cap, DAA sets individual prices for a range of airport activities (11 separate prices for current 2009 pricing). Volumes of activity and the mix of these activities which can be subject to different drivers need to be estimated for the season or year ahead. As previously noted to the Commission, DAA also seeks to provide pricing incentives to drive optimal use of certain airport resources, such as discounted remote parking, but the likely uptake of these can be uncertain. We have also noted that DAA strives to introduce any new pricing in line with the summer or winter seasonal planning periods used by airlines and to provide airlines with the maximum notice possible for price changes. Against this background, DAA's record of price cap compliance has been exemplary. The Commission has in each year confirmed that the DAA is compliant with the price cap. Despite the many external factors which can alter the price cap and hence the level of compliance, the highest variance to the prevailing cap was 7%, with the majority of variances being within 5% of the cap. Hence it is unclear why there is now a suggestion that the current provisions in this regard need to be altered.

The ability of the company to ensure absolute compliance is made even more complicated by the fact that the price cap has at times shifted considerably, sometimes even retrospectively. For example the price cap for 2003 of €5.29 was retrospectively adjusted downwards by €0.23 in 2004 following the interim review of the 2002 Determination. The company can and does attempt to achieve a level of compliance within the target price cap

when setting charges. However, the Commission has the ability to amend that cap after the charges have been set. It is not reasonable that DAA could be penalised for failing to comply with a price cap different to the one originally specified by the Commission, and moreover will be expected to rebate within 45 days of the year end any over-recovery. In such circumstances, the application of an arbitrary limit to the level of under-recovery of 5% of the cap is even more unreasonable and unfair when considered in this context. If the Commission proceeds with this proposal, it should also confirm that it will not alter the price cap it initially sets during the year, so that that unforeseen circumstances, such as appeals, interim reviews, etc, will only result in adjustments to future price caps and not retrospectively.

DAA believes that it is asymmetric and unfair for the Commission to propose that the remuneration to DAA of an under-recovery not only be delayed by up to two years, but also be capped at a level of 5%. As has already been noted, despite the company's best efforts, there can be many variables which affect DAA's ability to remain within the limits set by the Commission and it would be unfair to penalise DAA where genuinely unforeseen events impacted on the ability to achieve a close alignment between aeronautical revenues and the price cap. In this context it should also be noted that arbitrary limits to the level of DAA's under-recovery could lead to regulatory gaming by other parties.

The Commission does not appear to have considered the many practical difficulties of implementation of its proposals as it has not given any indication as to how the proposed rebate could or should be issued. For example:

- It is unclear what formula should be applied to calculate the rebate and whether the Commission considers that the rebate should be applied equally to all passengers for all airlines despite the fact that each airline may have a somewhat different average charge per passenger based on their aircraft size and dwell time.
- It is not apparent what the process should be if an airline has paid in cash and is untraceable
- It is unclear what should happen if an airline due a rebate has gone out of business

The implementation of the Commission's proposal would undoubtedly require the development of an extremely complex rebate system, which in turn would necessitate a considerable investment in billing software to work out:

- The retrospective adjustments that would be required (charges are currently priced at the rate applicable at a particular date) and which would result in either a net credit or debit being generated for each transaction. These adjustments, once generated in the billing engine would have to be uploaded and posted to individual customer accounts. At current levels this would entail re-pricing in excess of 200,000 movements per year.
- The exact charges to be used to calculate a price cap refund – e.g. to exclude or not, runway and parking revenue for cargo flights, which carry no passengers in the final calculation.

The implementation of the Commission's proposal would also have a major impact on DAA's reporting capability, in particular on reports used to monitor price cap compliance, as these are currently calculated based on the charge type, the unit and the fixed price. DAA would need to set up a new reporting system to reconcile the general ledger with airport charges revenues. The billing and reporting tools required for such a rebate system, further highlight the fact that the practical implications of the Commission's proposal have not been properly thought out.

The logic behind adjusting future price caps for under/over recovery was to remove all such problems in the first place. In fact, the Commission itself, on account of the significant administrative and cost burden involved in adjusting caps year on year, introduced the 12-month lag in 2005 precisely in order to reduce these difficulties.

DAA has made significant efforts to ensure that the Commission is kept aware of the level of compliance during the course of the year, and the current system provides for regular review of compliance throughout the year plus audited accounts. DAA is open to a further discussion of the contents and style of its regulated accounts, as has already been demonstrated in the course of agreeing changes in approach to this area in the past.

Under company law the DAA statutory accounts must first be validated and audited by an independent body. The DAA Board then approves these accounts, before they are presented to the DAA's shareholder at the DAA's Annual General Meeting (AGM). The DAA's AGM is usually held in April/May each year. The price cap compliance data is not submitted to the Commission until after the AGM. A requirement to alter this sequence would have serious implications, which would require testing from a legal perspective. It should be noted in this regard, that the pertinent section relating to the Regulated Entity Accounts of the Aviation Regulation Act 2001 (no amendments were made to this in the 2004 Act) states that:

S28 (1) The Commission may seek that a person in respect of whom it has been given a function under this Act shall keep accounts in such manner as the Commission may determine, in respect of the activities regulated by the Commission, separate from its other activities, and shall produce audited annual accounts in respect of its regulated activities which shall be submitted to the Commission within 6 months of the end of the accounting year. (2) The Commission may arrange to have examined, on an annual basis, the aforesaid accounts to ensure that a separation of accounts has been carried out

DAA believes there is a bias against the company in an approach whereby DAA will have to wait up to 24 months for remuneration of any under-recoveries, but is expected to pay rebates for any over-recovery within 45 days of the year end. This is particularly severe treatment in light of the fact that DAA's customers have not voiced concerns with the current system (as the Commission stated in paragraph 11.15 that Aer Lingus is satisfied with current price cap structure), and particularly where remuneration of under recoveries is also capped. The Commission has provided no compelling rationale as to why it proposes to change it now.

DAA welcomes the Commission's stated intention of allowing DAA to roll-forward any under-collections into future price cap calculations, which is a fair and appropriate development. DAA concurs with the Commission that proper compliance requires proper and adequate transparency. It follows, however, that the process of assessing compliance should also be carried out in a fair, reasonable and proportionate manner. The proposal as outlined illustrates that the Commission is approaching this area in a manner that is biased against the regulated entity and has little appreciation or understanding of the practical consequences of its actions. It is a further example of unnecessarily interventionist and biased regulation, which adds cost without value, as the airline users are under the existing arrangements, repaid any over-recovery due with interest. It is the view of the DAA that the Commission should reconsider its proposal to change the current structure in the light of these comments.

However, should the Commission persist with any change DAA recommends the following:-

- The price cap initially set will not be altered during the year for unforeseen circumstances, such as appeals, interim reviews, etc. Adjustments will be made to future price caps.
- The period for rebate should coincide with the 6 month legislative limit for the submission of the Regulated Entity Accounts
- No cap should be placed on the level of under-recovery that can be remunerated to DAA in future periods
- The Commission should clarify what form a rebate should take and how it should be rebated

8.3 Dublin Airport City

DAA welcomes the Commission's proposal to exclude Dublin Airport City (DAC) from the regulatory till on the basis that it has insufficient nexus to the regulated business. This view is consistent with that submitted by both DAA and the airlines in response to the Issues Paper.

The development of DAC will primarily take place on lands currently in the ownership of DAA that is either not currently utilised or is not required for core airport operational purposes. DAA's views on the Commission's proposals for addressing the disposal of properties from the RAB are set out in Section 6. It is however unclear whether a transfer from the RAB to another DAA entity would in fact be considered by the Commission as a disposal as described in the Commissions principles for roll forward of the RAB.