Aer Lingus

Dublin Airport, Dublin, Ireland

Telephone: Head Office 0818 365 022
General Fax +353 1 886 3832
http://www.aerlingus.com

Direct Telephone Number
(01) 886 2058

Direct Fax Number
(01) 886 2460

By email and post

22nd June 2010

Mr. John Spicer,
Commission of Aviation Regulation,
3rd Floor,
Alexandra House,
Earlsfort Terrace,
Dublin 2

RE: Consultation on the decisions of the 2010 Aviation Appeal Panel

Dear Mr. Spicer,

See attached submission by Aer Lingus in relation to the above mentioned CP1/2010. Please acknowledge safe receipt.

Yours sincerely,

Laurence Gourley
Head of Legal

Response to CP1/2010

AER LINGUS RESPONSE TO THE COMMISSION'S CONSULTATION ON THE OUTCOME OF THE 2010 APPEAL PANEL

The Aer Lingus Appeal

Excessive retail overheads from T2

The Appeal Panel has referred back to the Commission for it to consider how the recovery of increased overheads associated with the over specification of retail space in T2 could be postponed until they are commercially justified. The Aer Lingus appeal on this matter relates to a knock-on impact resulting from the over-specification of T2. This relates to the significant amount of excess retail space provided in the new terminal.

T2 contains a vast amount of space earmarked for retail development which will not be utilised for the foreseeable future because traffic numbers are insufficient. The Commission's Determination allows the costs of this unused retail space to be passed on to airport users because the Commission is forecasting no increase in the DAA's retail revenues on the opening of T2.

Even though retail development does not fall within the scope of services regulated (or protected) by the Commission, this decision has the effect of passing the cost of this excess retail space on to airport users. This appears to result in the DAA receiving regulated support via airport charges for excessive development of retail space. In our view, this falls outside the scope of airport charges that the Commission is charged to regulate under the legislation and is an unusual circumstance within single till regulation. This form of regulation derives from the difficulty of separating the costs of aeronautical and non-aeronautical aspects of airport facilities. Rather than do this, all costs are included, but estimated revenues from non-aeronautical services are netted from total costs before computing allowable airport charges. This approach works provided non-aeronautical facilities are efficiently used. But if the airport simply develops a significant amount of excess retail space in advance of it being needed, as in this case, then the effect is to make airport users provide pre-financing for excess retail space that the airport has built. This is a material error in the Commission's determination which exacerbates the sudden increase in aeronautical charges with the opening of T2.

In this case, we believe that the appropriate response should have been to use benchmarks of average retail revenue per m^2, from T1 or other airports, to attribute notional revenue to the surplus retail space. This would protect

airport users from bearing the cost of DAA's speculative retail investment and the Commission should vary its Determination accordingly.

The Ryanair Appeal

Differential price caps

In its response to Ryanair's appeal, the Appeal Panel has referred back to the Commission the matter of "how best differential pricing might be initiated". In the body of the Appeal Panel's response to Ryanair's arguments, the Panel expresses support for the idea that DAA should 'cater for different airline business models'[1] The Panel expresses the view that DAA, while free to charge on a differential basis, will not do so unless mandated to do so by the Commission. The Panel also comments that "a start could be made with a small nominal difference in the price cap between T1 and T2 once T2 is operational".[2]

There is no justification on economic grounds for differential pricing between the two terminals. Nor has the Panel demonstrated that the fact that the DAA does not offer differential pricing between the two terminals is a market failure that can only be remedied by mandating differential pricing.

The DAA already has an incentive to offer differential services at different costs to airlines if it is in its commercial interest to do so. The fact that the DAA is a monopoly does not negate this incentive. However, the DAA should not be mandated to charge differential amounts for services provided by the two terminals that are in effect providing the same standard of service to all airport users.

The fact remains that T2 is specified to provide service at IATA Standard C, which is the same standard as T1. T2 was constructed solely to provide additional capacity at Dublin Airport in the interest of all airlines and was not intended to provide a different level of service to that provided in T1. As both terminals offer the same standard of service it is entirely appropriate that the charge should be the same in both locations. Any other outcome would be economically inefficient and would represent unjustified price discrimination between the users of T1 and T2 which would also be unlawful under Irish competition law.

Indeed, we agree with the passage quoted by the Panel from para 10.10 of the Commission's Final Determination, which outlines the risk that mandating

---

1 Decision of the Aviation Appeal Panel 2010: Appeal of Ryanair, Para 8.4.7.

2 Ibid, Para 8.4.8.

price discrimination would lead to distortions in airlines' operational decisions. In particular, the Commission refers to the possibility of all airlines wanting to use one pier. The same argument applies to T2. Aer Lingus has agreed to relocate to T2 because it is operationally efficient for the airline to operate all its services from one terminal. However, the benefit of T2 will be felt by all airport users whether or not they relocate. Once T2 is operational, it will significantly reduce congestion in T1 to the benefit of all users there as well.

Aer Lingus has agreed to relocate to T2 but only on the condition that there will be no differential charging. If the DAA were to propose charging more for T2 than T1 then Aer Lingus would never have supported T2 and would not be in a position to relocate, as this would place it at a competitive disadvantage. T2 does not represent a higher standard of service but simply provides additional space in the same way as Pier D provided additional space in Terminal 1. In the same way as there would not have been any justification for users of Pier D being required to pay higher airport charges merely by virtue of the fact that it offered more modern facilities, differential pricing between T1 and T2 cannot be justified. Differential pricing between T1 and T2 would create precisely the sort of distortion that the Commission has highlighted. In fact it would leave T2 virtually unused which would defeat the whole object of expanding terminal capacity in the first place.

The rationale used by the Panel for differential pricing between terminals, summarised by reference to internet check-in and the need for check-in desks, totally misunderstands the manner in which charging currently applies at Dublin Airport which already takes account of the fact that different airlines may have different service requirements within a terminal. The Panel seem to be acting under the misapprehension that DAA operates a "one size fits all" pricing policy at Dublin Airport. This is not the case. The DAA already operates a system of pricing for different services that allows airline operators with different business models to choose from a menu of services in a way that best fits their business model. As a consequence, it is already possible for a "low cost carrier" to pay significantly reduced aeronautical charges compared to a full service carrier.

In the case of charges for the rental of check-in desks, these are not included within aeronautical charges determined by the Commission but are separately set by the DAA and approved by the Commission. The current approved annual desk rental is €25,000 per annum. Desks are rented individually so any airline that makes extensive use of on-line check-in already benefits from the savings it can make in reduced use of check-in desks. The same is true for automated check-in kiosks which are installed at the expense of the airline and are currently chargeable at an annual rate per kiosk. Charges relating to check-in facilities are merely an example of how airlines can choose different

levels of service within a terminal consistent with its individual business model.

In addition, the costs covered by aeronautical charges relate to the landing, parking or taking off of aircraft and include passenger related functions such as baggage handling systems and security screening. To the extent that these services are common across all airport users, there is no justification for providing a discount to a particular airline merely because that airline uses a particular terminal. Where an airline does not require a particular service or facility, the current charging mechanism already makes provision for different levels of charge.

By way of example, airbridges are currently charged at €7.35 per 15 minutes or part thereof. Consequently airlines can reduce their aeronautical charges by achieving faster aircraft turn-around times. Aircraft parking charges are also calculated per 15 minutes (or part thereof). This allows airlines to reduce charges by achieving fast turn-around times. Airlines also receive a significant "remote stand" rebate, with charges reduced from €10 to €6.30 per passenger if the airline chooses to use a remote stand rather than a contact stand. Overall, we estimate that under the existing schedule of charges at Dublin Airport, a low cost carrier can reduce overall charges by the order of €6 per departing passenger[3] compared to a legacy carrier by maximising the advantages of remote stands, fast turn-around times and internet check-in.

We note that there are relatively few examples of airports around the world that have introduced differential charging between terminals. This matter was analysed in detail in the 2007 Jacobs' report for the Commission.[4] Although this report found no clear pattern, it found that in general low cost terminal facilities are characterised by providing a service lower than the IATA Level C and / or by terminals designed without airbridges. Differentiation by service level standard is clearly inappropriate in the case of Dublin Airport because both terminals meet IATA Level C. As for airbridges, differentiation is already reflected in DAA's charging scheme because of specific rental charges for airbridges and discounted parking charges for remote stands. Furthermore, Terminal 1 has none of the other characteristics that would typify a low cost terminal such as the absence of any check-in technology, passengers carrying their own baggage between check-in and the baggage system, minimal retail/food and beverage facilities, minimal passenger service facilities (e.g. seating) and no premium lounges.

---

3 Calculated for a typical Airbus A320.

4 Review of dedicated low-cost passenger facilities"

We also note that the matter of differential charging was considered relatively recently by the UK Competition Commission in its review of airport charges at Heathrow and Gatwick Airports.[5] In that report, the Competition Commission noting the lack of differential charging between the new T5 and existing terminals[6] found that there were insufficient grounds to consider that the lack of differentiation acted against the public interest.

In summary, the existing scheme of charges at Dublin Airport provides ample scope for an airline to choose a package of services that substantially reduces the level of airport charges that it pays and it would be completely inappropriate to create a further tier of price differentiation by reference to the use of T1 and T2. Price differentiation could potentially be justified for different levels of service but this is not the situation at Dublin Airport. As well as being specified to the same IATA Service level, T1 and T2 provide appreciably the same range of services to airlines. The only material difference in service offered is that T2 offers Customs and Boarder Control Pre-clearance, which is not available in T1. However, airlines are charged separately for this service so this cannot be used to justify differential charging.

Finally, we note that differential charging between terminals (as opposed to charging for optional services) raises many practical and policy issues. First, any differential in charging must be clearly supported in terms of cost and service quality differences. Service quality differences are a necessary condition for differentials as without these differences charges should not be differentiated regardless of any cost differences. However measuring cost differences is extremely difficult and there are several different cost definitions that could be applied which may result in different answers.

Furthermore, if costs are to be differentiated, it becomes critical to identify which elements of costs are different and where the services from the two terminals are in fact provided by shared assets. For instance, T1 and T2 share use of Pier B so any cost calculation would have to clearly identify costs between the main terminal buildings and Pier B related costs. Similarly, all costs relating to runways, taxi-ways and aprons would need to be identified and separated as these costs are common between the terminals. Cost allocation exercises of this nature would require significantly more detailed regulatory accounting information than is currently provided by the DAA. Charges differentiation would also raise complex issues relating to the allocation of commercial revenues between the terminals. Such an exercise

---

5 Competition Commission (2007), BAA Ltd: A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)

6 Ibid para 6.58

could raise further policy issues relating to the allocation of commercial revenues between low cost carriers, other short haul services and long haul carriers.

T1X incremental revenue

Aer Lingus endorses the finding of the Appeal Panel that the effect of T1X should be neutral with respect to charges – that is aeronautical charges should be neither higher nor lower than would have been the case had T1X not been developed. This is clear from both the Final Determination and from CP6/2007.

We agree with Ryanair that simply attributing an amount of revenue to T1X in the price determination that matches the cost of T1X does not necessarily achieve the effect of neutrality. Specifically, if total projected commercial revenue for DAA as a whole is unchanged, but some of that revenue is attributed to T1X, then T1X appears to be charges neutral, but higher net costs drive up prices elsewhere in the regulatory calculation.

Charges neutrality using this methodology requires the Commission to attribute revenues to T1X that would not otherwise have been included in the settlement. Given the way in which commercial revenues have been calculated – linking revenues to passenger numbers - it seems very likely that total commercial revenues did not include an increment for T1X, whether or not a notional sum was attributed to the development.

In our view the stated objective of charges neutrality is most simply achieved by excluding the costs of T1X from the RAB. If the Commission is not prepared to take this step then it should present a revised calculation that explicitly adds to the existing commercial revenue forecasts, based on passenger numbers, an additional sum equal to the costs of T1X that need to be recovered.

The DAA Appeal

Double counting of PRM revenues

There has been some ongoing confusion in relation to the treatment of costs and revenues relating to the provision of services to PRMs in the Commission's Determination. Further to the decision of the Appeal Panel, the Commission should clarify this issue and, if necessary, correct its determination accordingly.

Treatment of inflation

Given the excessive size of the price rises implemented in 2010, Aer Lingus is extremely concerned at the suggestion that the RAB should be increased by a further €59m. It also appears from the proceedings of the Panel that this is a matter that was already considered, and rejected, by the Commission.

As regards the possibility of treating this issue simply as a mathematical error, Aer Lingus is extremely concerned at the prospect that the Commission might mechanically re-index the DAA's CIP budget and award the company a further €59m. If it is the case that the DAA's CIP was prepared in nominal terms with a provision for inflation of 4% in 2009, then it is extremely likely that investment costs in 2009, and projected for the relevant control, will be hugely exaggerated in nominal terms. In our view, therefore, if the Commission were to identify a discrepancy between inflation assumptions, it cannot simply increase all of the DAA's projected costs in real terms. Rather it must conduct a proper investigation into the appropriate level of costs given that we now know that the price level fell by almost 7% in 2009. The Commission should also take into account projected savings that will accrue as a result of this reduction in prices in general.

The disallowance of €15.3m in respect of Pier D costs

The Panel has referred back to the Commission the issue of disallowed costs relating to Pier D. The Panel expressed concern about the reaction of capital markets if "large tranches of past investment" are disallowed.[7]

We disagree with the view of the Panel and stand by our earlier views that the additional costs of Pier D should be excluded from the RAB. These costs were not included in the 2006 CIP and did not form part of the earlier price settlement. So it is not the case that costs previously allowed are being retrospectively disallowed.

Dealing with cost variations of this nature form an intrinsic part of the settlement under price cap regulation and the risks associated with such cost variations are included in the cost of capital. The DAA benefits if it is able to deliver its outputs below the projected costs but is penalised if its costs overrun. In this way, the company is induced to try its hardest to deliver its outputs as efficiently as possible.

We believe the Panel's concern about capital markets is misplaced, because no adverse precedent is being set. This is not a case of the Commission disallowing costs that were included in a final regulatory price control. Rather

---

7 Decision of the Aviation Appeal Panel 2010: Appeal of DAA, Para 8.5.12.

it is a matter of debate between the regulated company and the regulator over the justification of ex post changes to that settlement.

We consider that the Commission has behaved in an appropriate manner and no change should be made to the Determination in this regard. If the Commission were to begin to allow cost overruns then the whole system of regulation would be in danger of becoming one of cost-pass-through rate of return regulation. Such systems are known to lead to over-investment and inefficiency.

The disallowance of temporary forward lounge ("TFL") costs of €6.2m and Pier D fit-out costs of €1.2m

We believe that the Commission should reject the DAA's arguments with respect to the fit out costs of Pier D for the same reason that we oppose the inclusion of cost overruns. These were costs that were not included in the 2006 CIP or the previous price control. They therefore constitute part of the risk that the DAA takes in the investment process and for which it is remunerated through the cost of capital.

The DAA's argument[8] appears to be that it forgot to include these costs in its original CIP. We consider that the duty on the DAA under the price control regime is to make the best estimates it can of the efficient costs of its investment programme. If it has done this, then it will be the case that some costs will come in below budget and some over budget. The DAA should not then be allowed to appeal for the restitution of the over-runs without complete consideration of the savings. Such an approach would undermine the incentive properties of the regime as a whole and we therefore oppose this application.

---

8 Ibid, Para. 8.5.22.