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Ms. Caroline Wander,
Commission for Aviation Regulation,
3rd Floor, Alexandra House,
Earlsfort Terrace,
Dublin 2.

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Dear Caroline,

Please find enclosed Aer Lingus' response to CP 1/2012, Future Investments and the Regulatory Till, which we have prepared in conjunction with Frontier Economics.

As referred to in the paper we see much opportunity for the Commission to develop further the proactive and progressive ideas and concepts which are put forward.

We are of course available for further engagement on this at your convenience.

Yours sincerely,

Ken Millar

Aer Lingus - Operations Contact Manager

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Future Investment and the Regulatory Till

A RESPONSE TO CP1/2012

This note sets out a response to the Commission for Aviation Regulation's consultation on how to define the boundary of the single till.

Aer Lingus welcomes the opportunity to respond to CP1/2012, which is a follow-on consultation from CP4/2010 that explored the issue of single-till regulation for Dublin Airport.

We welcome the Commission's considered response to that consultation. We are happy with the Commission's précis of our views on the issue of single till, and are unsurprisingly pleased that the Commission has stated that it tends to agree with our analysis of the way airport pricing and competition works. As a consequence, we have endeavoured to keep our response to the latest consultation as short as possible.

In summary, we believe the Commission needs to establish a set of guidelines which it will use to decide where the limits to the single till should be. On the whole we are sympathetic to the process set out in the consultation, but are concerned that the Commission may be missing some important nuances that could undermine the single till in the medium term.

The Commission seems to be trying to avoid addressing the matter of principle regarding which activities should or should not lie within the single till, instead breaking the matter down into the practicalities of cost allocation and the ability to reach consensus between the parties.

We are not confident that this is sufficient. We believe there are non-aeronautical activities which should, as a matter of principle remain within the single till – when there are material demand complementarities with aeronautical services. Furthermore, we are concerned that the consensus test could be manipulated to remove items from the single till for short-term commercial reasons rather than fundamental ones of economic efficiency. A clearer line on the principle of what should be in the single till should protect against this risk.

The Commission's proposed process for removing activities from the Single Till

In the flow chart at para. 1.5 the Commission suggests a two-stage process for determining whether an activity should be removed from the single till. The two stages are:

- are the costs and revenues easily separable?; and
- is there consensus between users and the airport on the issue?

What is striking about this process is it avoids any discussion of whether there are activities which should remain within the single till or be excluded *as a matter of principle.*

The feasibility of separating costs is not sufficient

We agree that the ability to separate costs from the generality of airport activities is a *necessary* condition before an investment can be considered for removal from the single till, but we do not think it is a *sufficient* condition. Nor do we think that obtaining consensus between the parties provides an adequate subsequent decision rule.

To explain this we think it is necessary to step back and reiterate briefly the economics of airport pricing as set out in our response to CP4/2010.

Where economic rents[1] from non-aeronautical activities are a direct function of the level of aeronautical activity (where there are demand complementarities) a competitive airport will be obliged to reflect these rents in lower aeronautical charges, at least in the medium term. It is true that an airport with market power over aeronautical services will still pass on a proportion of these economic rents in lower airport charges, but not to the degree that would be expected in a competitive airport. This price interaction depends on the presence of locational rentals in the non-aeronautical services, not on market power in these services. The effect of excluding these non-aeronautical activities from the single till is felt in excessive aeronautical charges, not in charges for the non-aeronautical services, which may well be determined in a competitive environment.

Hence, as a matter of principle the Commission's first test: whether costs are separable, is insufficient to put forward an investment to be removed from the single till. In our view the necessary decision rule is:

Is accounting separation of costs straightforward? **and** Are expected profits from the activity independent of aeronautical activity at the airport? The investment

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1 Defined as profits generated above the competitive rate of profit.

should only be considered for removal from the single till (and the RAB) if the answer is yes to both questions.

Relating this to various potential examples, it is clear that an investment in a commercial activity completely removed from the airport would meet this test. Commercial space rentals inside the terminals would not. Car parking would also fail this test.

Allowing for consensus does not compensate for the lack of principle underpinning the first test

We recognise that the Commission could argue that our concerns about the first test are misplaced, because the second test, the need for consensus, can deal with this problem. By way of example, if DAA were to seek to exclude car parking from the till it could be expected that the airlines would refuse if they believed that this would have a detrimental impact on aeronautical charges.

This may be true in some circumstances, but not all. This is because the Commission's proposals do not consider the *reasons* why a consensus might form between airport and airline.

In particular the airlines' view of an investment proposal by DAA will relate to the validity of the proposal *per se*, as well as any interaction with aeronautical charges, even if the proposal is generally deemed sound.

Referring back to the example of car parking: how would the Commission's proposal work if DAA were to propose a vast increase in car park capacity that the airlines considered unsustainable? In this circumstance it is possible consensus could be formed around excluding this development from the single till and (by extension from the section of the consultation on policing the boundaries) as a consequence all car parking assets would be removed from the RAB. So, by proposing an excessive development of car park capacity the airport could engineer a situation where a service is excluded from the single till which should in principle be included. Having achieved exclusion of car parking from the single till the airport could also subsequently modify its investments to a "reasonable" level, completing an effective "coup" against the regulatory system.

Regrettably therefore, we conclude that basing the decision to exclude items for the single till on consensus is insufficient to ensure efficient behaviour and could lead to gaming by the airport.

Further issues still needing resolution

Summing up, our view is that investments should only be excluded from the single till if costs are clearly separable, if demand complementarities with aeronautical services are weak or non-existent and then if airport and airlines can reach a consensus on their exclusion.

In that event we agree with the Commission that exclusion of an investment from the RAB should be accompanied by exclusion of the whole category of assets. This means that the exclusion of the total class of assets would have to be the matter on which consensus is reached. We further agree with the Commission that the removal from the RAB of any existing assets should be done in such a way as to leave aeronautical charges unchanged.

This nevertheless leaves the Commission with some problem categories, in particular:

- investments where demand complementarities clearly exist, but the airport wishes to invest more than the airlines are willing to agree to include in the RAB; and
- investments where demand complementarities are weak or non-existent at present, but may develop over time.

In these cases the idea sketched at 3.21 of the consultation – some form of profit-sharing arrangement – seems to have some merit.

We consider that profit sharing arrangements do have the potential to facilitate consensus between airport and airlines on more contentious investment decisions. However the dynamic implications of specific forms of agreement should be considered carefully and would require detailed regulatory modelling.

For instance, a simple sharing arrangement, where a proportion of the investment and a similar proportion of the resulting profits were included in the regulatory till would leave airlines less exposed to the risks of over-investment by the airport. But this would still have the characteristic of the present regime, that the airlines could end up underwriting losses on the airport's commercial ventures, albeit only partially.

Even in a sharing arrangement regulatory best-practice dictates that regulated monopolists should not keep the benefits of "outperformance" indefinitely. At some point super-normal profits relating to regulated activities should be passed back to consumers. Presumably the same principle should apply to projects having significant demand complementarities with aeronautical services. This begs the question whether it is appropriate to place any such activities wholly outside the scope of regulation?

An alternative option that perhaps could be considered would be one where:

- the investment is retained within RAB,
- the airport guarantees that the project will pay a minimum level of revenue back into the single till, so in setting aeronautical charges the Commission would assume that revenues generated were equal to this guaranteed amount, regardless of their actual level, and

- the airport would be allowed to retain the benefit of any excess return above this level for a specified period.

The second rule here would provide reassurance that the airport is not underwriting the commercial venture, because the minimum could be set at such a level that aeronautical charges are unaffected by the project. The third rule would ensure that the airport would have an incentive to pursue profitable projects. But by maintaining the investment in the RAB it would be possible for the Commission to prevent the airport from generating super-normal profits indefinitely, by relating returns to a RAB valuation.

This is just a suggestion which would require more thought and careful modelling. In particular, the calibration of the profit-retention period is important to balance protection of current and future airport users with the incentives for the airport to innovate.