DublinAirport

DUBLIN AIRPORT

“Response to Draft Decision on the Interim Review of the 2014 Determination of the Maximum Level of Airport Charges at Dublin Airport”

3 March 2017

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Response to CP1/2017
"*Draft Decision on the Interim Review of the 2014 Determination of the Maximum Level of Airport Charges at Dublin Airport*"

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1. Executive Summary

daa welcomes the opportunity to respond to the Commission for Aviation Regulation's (CAR) draft decision on the regulatory treatment of the North Runway at Dublin Airport. This project is of significant importance to the airport, its airline customers and passengers, and indeed, infrastructure development for Ireland as a whole.

The North Runway will be the second largest capital project undertaken by Dublin Airport (after Terminal 2) under the current regulatory system, and was subject to comprehensive assessment and public consultation as part of the regulatory process to arrive at the 2014 Determination. In that process a single, volume related trigger of 25 million passengers in a 12 month rolling period, was set for this project. On realisation of this traffic volume, an increase of €0.59 (2014 prices) to the base price cap in the subsequent years would be made. This 25m passenger volume was reached in 2015, earlier than had been anticipated by either CAR or daa when the regulatory determination for the current period was being made in 2014. Towards the end of 2015, CAR indicated its intention to review the regulatory treatment of the North Runway to better align the remuneration of the project with the commencement of construction.

In its Draft Decision for this Interim Review of the North Runway, CAR proposes to maintain this €0.59 price cap adjustment but associate it with the attainment of three sequential milestones in the delivery of the project. A number of other proposals are also made in relation to the treatment of volume risk and the future reconciliation of any variance in project expenditure to capital allowance.

In general, daa favours a number of smaller adjustments to the price cap for remuneration of the project in preference to a single larger adjustment. By adopting such an approach, a spike in the price cap could be avoided or, at least, made less extreme. As our pricing strategy for the current regulatory period is to maintain flat pricing for our airline customers, to the extent possible under the price cap regime, we would welcome such an approach. However, within the current proposal there remains a large single adjustment to the price cap (85%) which will result in simply postponing the significant spike in the price cap rather than its smoothing. We believe, therefore, that scope remains for further flattening of the impact of the North Runway remuneration on the price cap/level of airport charges.

CAR has also proposed a radical change in regulatory policy with regard to where volume risk on the North Runway investment is to be borne – volume risk on the North Runway, and on this project only, would be removed from Dublin Airport. This policy shift, if pursued, will have a number of negative implications both for the mechanics of ensuring remuneration of the project, but also in the wider arena of how the stability of daa's regulatory environment is assessed. This proposal is contrary to CAR's position on volume risk since the introduction of economic regulation for the airport. The regulatory certainty provided by the current regulatory system is viewed positively by the financial markets and, therefore, the reduction in regulatory certainty as a result of this proposed reversal of long-established policy is unwelcome. Additionally, a mechanism to calculate gains/losses in aeronautical revenues arising from volume risk on the North Runway price cap adjustments will be required and also a mechanism to adjust the Regulatory Asset Base (RAB) values to reflect the gains/losses so calculated. The introduction of these mechanisms will serve to make visibility of the price path from economic regulation more opaque and so hinder business planning for both Dublin Airport and airlines. For these reasons, we do not favour this policy change.

Finally, CAR has also provided detail on the circumstances under which they would potentially amend the €247m (July 2014 prices) capital allowance for the North Runway in the future, and the process to be followed by daa for such amendment to be considered. In general, we consider CAR's rationale to be fair and measured, however, we have some concerns in relation to how additional costs arising from scope changes to the project to deliver operational efficiencies rather than compliance with regulatory requirements are to be assessed for entry to the RAB.

There are, therefore, four main areas within CAR's draft decision paper addressed in this document:

- The reallocation of volume risk (from airport to users),
- The retention of €0.59 as the total of the price cap adjustments to be made for remuneration of North Runway,
- The number, monitoring of, and nature of the milestones proposed for the remuneration of the project,
- Treatment of cost variance from allowance in relation to different drivers of cost variance, with particular concern relating to the treatment of cost variances arising from scope changes to the project to deliver operational benefit (i.e. not in response to a regulatory requirement).

Our view of the proposals within the above areas is summarised in Table 1:

Table 1: Summary of daa response to CAR proposals

CAR proposal	Summary of daa position
Removal of volume risk from Dublin Airport on North Runway	**Volume risk should be borne by daa:** • This approach is consistent with regulatory policy to date and the treatment of all other assets in the RAB. • Price increases as a result of volume risk adjustment in periods of demand contraction may not be feasible. • The CAR proposal is asymmetrical with regard to potential protections afforded to airlines / Dublin Airport. • The introduction of complex mechanisms for RAB adjustment/price cap calculation should be avoided. • No substantial grounds for a reappraisal of the bearing of volume risk have been established.
Retention of €0.59 as total of price cap adjustments	**The price cap adjustment should be calculated from the RAB value to be remunerated rather than vice versa. This approach:** • Would avoid the introduction of further adjustment mechanisms for the RAB value of the North Runway. • Is consistent with the underlying rational of price cap regulation – that the price cap reflects the remuneration of efficiently incurred capital investment.
Remuneration of North Runway aligned to 3 milestones for project delivery	**The number of milestones should be expanded:** • To allow for a smoother price cap. • To protect the financial viability of daa under all possible scenarios, including a potential recessionary scenario, which would also protect airlines from a higher cost of debt being reflected in the Weighted Average Cost of Capital (WACC) in future determinations.
Potential for future reappraisal of €247m capital allowance and 50/50 risk-sharing mechanism based on cost changes arising from: - Materials - Scope changes – regulatory requirements - Scope changes – not regulatory requirements	**We agree that the North Runway capital allowance should be reassessed at a future date:** • For cost changes arising from cost in materials CAR must give adequate consideration to the level of Construction Price Inflation/tender returns. • Scope changes from regulatory requirements must encompass changes in estimated costs associated with mitigation schemes, as agreed with planning authorities/affected community as well as those required to comply with EASA regulations on Aerodrome Design and Operation. • CAR's proposal in relation to scope changes which are not a regulatory requirement does not take sufficient account of the potential for perverse incentives and regulatory gaming.

2. Background to Interim Review of the North Runway

In CIP 2015-2019 Proposals, submitted to CAR in April 2014, daa included three North Runway related projects – CIP 15.5.018 (North Runway Fees & Planning), CIP 15.6.019 (North Runway Advance House Purchase) and 15.6.051 (North Runway) - with only one of these projects, CIP 15.6.051, having a volume related trigger. In the 2014 Determination, CAR made a single €247m capital allowance to allow for the remuneration of all three North Runway related projects proposed by daa, and applied a volume trigger of 25m passengers in a 12 month rolling period to this amalgamated capital allowance. The capital allowance made was considered by CAR to appropriately remunerate Dublin Airport for efficiently incurred costs associated with planning application/amendment, project design, construction and commissioning as well as the costs of mitigation schemes arising from the North Runway project.

The attainment of the trigger condition would result in the addition of €0.59 to the base price cap in the subsequent year (and all remaining years in the current determination period). The price cap adjustment of €0.59 was calculated from a remuneration function[1] with independent variables of:

- €247m capital allowance;
- a 50 year asset life for the North Runway;
- WACC of 5.8%;
- an annuity depreciation profile; and
- passenger traffic[2] of 25m.

The addition to the base price cap in the years of the current regulatory period subsequent to the attainment of the trigger condition would be independent of the level of passenger traffic thereafter, with volume risk on this project being borne by Dublin Airport. The opening RAB in 2020 would then increase by the €247m allowance (appropriately adjusted for depreciation in the current period) with the remuneration of the North Runway being captured within the base price cap from 2020 onwards. The impact of this investment on the price cap in future periods would be calculated based on remaining RAB value, WACC, depreciation profile policy and passenger forecasts for those periods.

In summary, on publication of the 2014 Determination, the following was established:

- The North Runway project would commence annual remuneration during the period between the attainment of the trigger and the completion of the project i.e. a period of pre-funding up to operational runway being delivered[3];
- The full €247m allowance would be recoverable by Dublin Airport through depreciation over the 50 year asset life of the project;
- €0.59 represented the appropriate price cap adjustment to effect North Runway remuneration based on best estimate of traffic volume at the time of trigger attainment; and
- Dublin Airport would bear the subsequent volume risk on this project.

[1] See sheet '2015-2019 triggers' in the Financial Model for the 2014 Determination which can be found here : http://www.aviationreg.ie/regulation-of-airport-charges-dublin-airport/2014-determination.576.html

[2] The price cap adjustment for the three non-volume related trigger projects in the 2014 Determination was based on the average annual passenger forecast for the period 2015-2019. As the North Runway project would not trigger at such a traffic level, 25m was the best estimate of the traffic level likely to pertain at the time that the trigger would be met.

[3] For clarity, the total remuneration of the investment occurs over a 50 year asset life ,and is unaffected by whether pre- or post-funding pertains. The decision to allow pre- or post-funding affects the date of commencement of remuneration only.

In 2015, passenger traffic at Dublin Airport exceeded 25m passengers, meeting the trigger condition for remuneration of the North Runway. In line with the 2014 Determination, this should have resulted in an increase of €0.59 (2014 prices) to the base price cap from 2016-2019. However, on 22nd December 2015, CAR published CP2/2015 "*Decision on Conducting an Interim Review of the 2014 Determination of the Maximum Level of Airport Charges at Dublin Airport*"[4]. In this Commission Paper, CAR first indicated its intention to conduct an interim review of the 2014 Determination in relation to the North Runway. In conjunction with this stated intention, CAR advised that daa should not price in the €0.59 adjustment in setting airport charges for 2016[5], and subsequently reiterated this advice in relation to the setting of airport charges for 2017[6]. Dublin Airport has followed this advice in the setting of airport charges in both 2016 and 2017 and, therefore, the current level of airport charges at Dublin Airport does not reflect any element of funding for the North Runway project.

In CP2/2015, CAR stated "*The Commission believes that there are substantial grounds for conducting an interim review of the 2014 Determination in order to possibly amend the runway trigger…*"[7]. The reasons given for considering an Interim review to be warranted were that "*full funding of the project for a significant period of time in advance of construction would be exceptional….[and]… incompatible with the aims of price cap regulation*[8]". CAR further stated (paragraphs 3.3 and 3.6) that they had a rational expectation based on daa CIP 2015-2019 Proposals submission[9] that the North Runway project would be at a stage of development which would allow for construction commencement to align with the €0.59 entering the price cap. As this was not actually the case "*Allowing remuneration of the runway project before significant expenditure occurs would compromise the objectives of the original determination*[10]*.*"

With CP4/2016, CAR opened consultation on the scope of this Interim Review of the 2014 Determination relating to the regulatory treatment of the North Runway, noting that they had received three representations from users "*requesting that the review* [as signalled in CP2/2015] *be expanded to include additional aspects of the regulatory treatment of the runway project. The cost allowance and the risk sharing mechanism for cost over or under runs are the main aspects which parties requested the Commission review".* Six further submissions were made to CAR in response to CP4/2016.

In CP6/2016, CAR confirmed the scope of the review; "*We will therefore limit the scope of the review to the timing of trigger to better align remuneration with the timeline of the project as indicated previously in the December 2015 Decision and any enhanced reporting and monitoring that may be required*[11]". CAR also stated in Paragraph 1.4 that "*the Commission has decided that there are no substantial grounds to include the cost allowance, the risk sharing mechanism*[12] [referring here to

[4] This document provided a decision on an application for interim review of the 2014 Determination, made by daa on a separate issue which was unrelated to the North Runway.

[5] Paragraph 3.9, page 7.

[6] Correspondence of 14 October 2016 from Dr. Adrian Corcoran, Director of Economics - CAR to Valerie Ní Fhaoláin, Head of Economic Regulation, Pricing & Incentives – Dublin Airport.

[7] CP2/2015, paragraph 3.1, page 6.

[8] Noting that the current expectation, as of Q1 2017, is for remuneration of the North Runway to begin after the commencement of construction and therefore this concern may be considered to have diminished in relevance since the publication of CP2/2015 in December 2015.

[9] Dublin Airport's proposal was for a non-triggered capital allowance to progress the planning phase for the North Runway; this proposal was subsequently superseded by CAR's decision in the 2014 Determination to amalgamate the three North Runway related projects and apply a volume related trigger to the total capital allowance made.

[10] Paragraph 3.7, page 7.

[11] Paragraph 1.4, page 1.

[12] In paragraph 1.6, CAR do not rule out future assessment of the existence of substantial grounds for Interim Review in relation to the cost allowance for the North Runway, "I*f the final cost estimates are substantially different to the allowance,*

the sharing of risk relating to cost variance against capital allowance rather than volume risk]*, the runway length or capacity assessments in the scope of the review*". It is this scope, based on the substantial grounds found to exist for each element in CP6/2016, which provided the framework for "*Draft Decision on the Interim Review of the 2014 Determination of the Maximum Level of Airport Charges at Dublin Airport*" - to which this document responds.

2.1 Current Status of North Runway Project

With the attainment of 25m annual passengers in 2015, further progress has been made on the delivery of the North Runway project. An application for extension of the planning approval previously granted has been made, enabling works (Construction Package 1) have commenced following a competitive tender process, and there is on-going engagement with both the affected community and Fingal County Council in relation to the mitigation schemes (insulation and house buy-out) associated with this infrastructure development. Currently, Construction Package 1 (including services relocation, road realignment and site clearance) is underway, with expected completion in the current calendar year. Tender design for the main construction works (Construction Package 2) is being progressed concurrent with Construction Package 1. Works on Construction Package 2 will follow the award of the contract for that work package and a period of runway commissioning will be required on completion of the construction. Dublin Airport has incurred costs in relation to this project in all years since the 2014 Determination and the time profile of these costs will be discussed further in Section 5.3.

3. Reallocation of Volume Risk

As described previously in Section 2, the 2014 Determination assigned volume risk for all capital investment, including the trigger projects, to Dublin Airport for the duration of the regulatory period. CAR has adopted this approach to volume risk consistently with respect to all investment activities since the introduction of economic regulation to Dublin Airport in 2001. It is unclear to us the precise regulatory issue which CAR is seeking to address with this proposal, nor why any such issue would only relate to the North Runway and not to other investment at the airport. It is our view that volume risk of the North Runway investment should be borne by Dublin Airport and we do not support this proposed regulatory change. The following sub-sections set out the reasons why we hold this view.

3.1 Volume Risk in the 2014 Determination

In the 2014 Determination the trigger for the North Runway was set at 25m annual passengers. The attainment of this trigger would result in the adjustment of the base price cap in the following year by +€0.59, with the €0.59 calculated as the depreciation (annuity basis) of, and 5.8% return on, the €247m capital allowance for the North Runway spread over 25m passengers (the North Runway passenger volume trigger). In the event that the volume trigger was achieved, daa would bear volume risk until the asset entered the RAB in 2020 and the residual depreciation and return would form part of base price cap calculation for 2020 and subsequent years. This treatment of the North Runway project is consistent with the approach adopted for all other regulatory assets in the 2014 Determination. The issue of volume risk was consulted on in the 2014 regulatory determination process and airlines supported volume risk being borne by Dublin Airport. This was unsurprising as on all previous occasions when users have been asked their view of volume risk there has been unanimous support for it to be maintained by the regulated entity.

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then the 50/50 risk sharing mechanism may not be appropriate. At this time, setting a new allowance would be premature; given we have not reviewed, in any detail, the recent estimates suggested by Dublin Airport. Rather, in our draft decision paper we plan to set out a process by which we may move from 50/50 to constructive consultation to deal with a cost which differs from the allowance."

3.2 Inconsistency with Treatment of Other Assets

In CP1/2017, CAR proposes to remove the volume risk from daa on the three price cap adjustments (aligned with the three milestones for remuneration proposed) through RAB adjustments, over the entire 50 year asset life of the North Runway. To effect this change in approach will require both the holding of the North Runway capital allowance separate from the overall RAB for Dublin Airport and also holding the price cap adjustments separate to the base price cap over the entire 50+ years over which the remuneration of the North Runway will occur.

In general, daa believes CAR's proposed approach not only adds an unnecessary element of complexity to RAB adjustments, but is inconsistent with CAR's previously stated position with regard to the appropriate body to bear volume risk as per the 2014 Regulatory Determination: "*We are satisfied that the allocation of risks in this Determination is appropriate. Someone will have to bear the risks of extraordinary events affecting passenger numbers over which DAA has no control; our approach is symmetric, assigning both the upside and downside risk to DAA. Moreover, outside of extraordinary events, DAA is the party most able to control passenger numbers at Dublin Airport. This Determination rewards DAA if it is able to promote additional traffic at Dublin Airport*[13] ". daa consider the proposed reallocation of volume risk for one single asset, in isolation, to be inconsistent with the approach to volume risk taken in the 2014 Determination in relation to the entirety of the RAB i.e., pre-2015 assets, capital allowances made for 2015-2019 period and other projects which may potentially trigger during the current regulatory period.

3.3 Commercial Viability of Reallocating Volume Risk

Were annual passenger numbers to fall back to below 25m the outcome of this approach to volume risk would see an increase in the price cap (all else equal) at a time when the aviation sector would be in difficulty[14]. This approach to volume risk would give rise to increasing price cap at times of falling demand. This is a presumption that it would be commercially viable for Dublin Airport to raise prices in such trading circumstances, which may not always be the case. Very recent experience (2017) has shown that airline customers can and will remove capacity from Dublin Airport where they consider that their costs for aeronautical services at Dublin Airport are not reducing[15]. Economic theory suggests a similar effect on the level of passenger traffic should be expected in circumstances where prices were rising. In effect, this reallocation of volume risk could give rise to an upward spiralling of the price cap adjustment for the North Runway, which could further exacerbate the shortfall in traffic that would have triggered this situation in the first place. Whether the projected increase would prove commercially viable in practice is therefore highly doubtful.

3.4 Asymmetry of Effect of Proposed Change to Volume Risk

We consider CAR's proposal to not only be a deviation from their overall approach to the bearing of volume risk, but also from the symmetrical form they indicated they would pursue in the 2014 Determination. Passenger numbers at Dublin Airport were 27.9m in 2016; as per CAR's proposal passenger numbers would need to decline by c.3m before Dublin Airport could be said to benefit from the proposed approach to volume risk, with no reciprocal requirement for passenger numbers to rise by 3m before airlines could be said to benefit from the proposed approach. The asymmetrical nature of CAR's proposal is illustrated in Chart 1.

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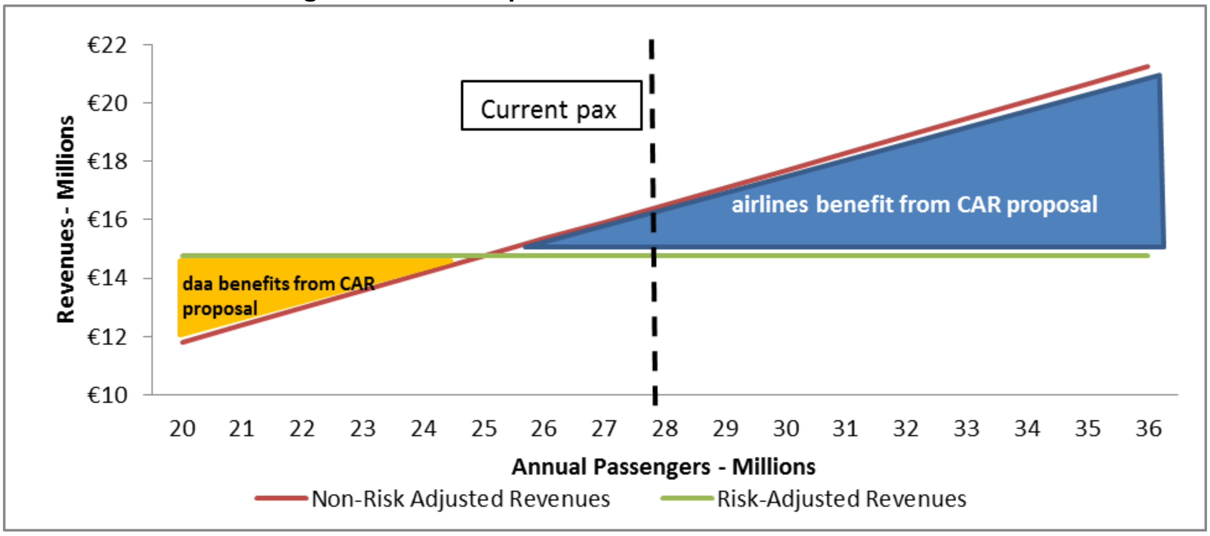
[13] CP2/2014 "*Maximum Level of Airport Charges at Dublin Airport -2014 Determination*" paragraph 3.18, p36

[14] A drop of 2.9m in annual passengers is similar in absolute terms to that experienced between 2008 and 2009 as Ireland entered a period of economic crisis, although it would represent a 10% drop from current volumes rather than the 12.6% represented at that time.

[15] On 24th January 2017 Ryanair announced a 3% cut in capacity at Dublin Airport citing daa's 'rising costs'https://www.rte.ie/news/business/2017/0124/847313-ryanair-winter-schedule-2017/. This drop in capacity comes during a period of GDP growth and falling unemployment and so cannot be as simply attributed to a drop in demand in the Irish market as may have been considered to be the case in the last period of capacity contraction in 2009/2010.

Chart 1: Benefits Accruing from CAR's Proposal on Volume Risk*



*Revenues are calculated as €0.59 * annual passengers

3.5 Complex Mechanism Required to Effect Proposed Change

In order to remove volume risk from Dublin Airport for the North Runway, a complex mechanism will be required to provide 5-yearly adjustments to the depreciation charge offsetting the RAB value of the North Runway asset at each regulatory period.

The first adjustment will be required to calculate an adjustment to the opening RAB value of the North Runway to account for any variance of annual passenger forecasts (above or below 25m) from the prior regulatory period. A second adjustment will be required to adjust the runway price cap element for addition to the base price cap to take account of the difference between CAR's passenger forecasts in the regulatory period under review versus the original 25 million passenger base used to calculate the price element for the runway.

This process of dual adjustment will be required throughout the 50 year asset life of the investment. All else being equal (e.g. if the base price cap was flat) the result of these adjustments (assuming some level of variance between passenger forecasts and outturn) would be a spikier price cap profile.

Given current CAR policy is to provide for a smooth price cap path through acceleration of depreciation, and on the assumption that this policy will be continued, this more variable price cap profile would give rise to a greater requirement for adjustments to the depreciation profile of other assets in the RAB[16]. While the mechanics of the proposed change are technically feasible, consideration should be given to the long length of time over which this mechanism would need to be maintained. Over the 50 year asset life of the North Runway many further regulatory decisions with potential impact on the calculation of the RAB are to be expected, which could greatly increase the complexity of the mechanism proposed. In the 2009 Determination, CAR introduced a complex mechanism for the treatment of the T1X investment (extension to the retail space in Terminal 1). The T1X mechanism was abandoned in the 2014 Determination with CAR citing *"...repeating such an* exercise [calculating an uplift on retail revenues of account of expected incremental revenues from T1X]*, and attempting to isolate the effects of T1X for retail revenues, is now near impossible*[17]." This example of the difficulty experienced in incorporating further adjustments into complex

[16] All else remaining equal.
[17] Paragraph 6.32 of the 2014 Determination (p65).

mechanisms, even over a single regulatory period, calls into question the desirability of introducing complex mechanisms into the price cap calculation, as is proposed again in this case. It should also be considered that the proposed CAR mechanism would be expected to be in place for at least 10 regulatory periods (assuming current 5 year period length is maintained).

3.6 Volume Risk within Scope of the Interim Review

Finally, the proposal to change the approach to volume risk (from that set out in the 2014 Determination) has not been demonstrated to be within the scope of this Interim Review. It was not addressed in any of the previous documents - CP2/2015, CP4/2016, CP6/2016 or CP1/2017 - relating to this Interim Review. We require confirmation of the in-scope nature of this proposal, together with evidence of the existence of substantial grounds in relation to this element, as part of this consultation process.

4. Requirement to Retain the Price Cap Adjustment at €0.59

In making the 2014 Determination, CAR calculated a price cap adjustment of €0.59 was required to allow Dublin Airport earn the regulatory WACC of 5.8% on the efficiently incurred cost of the North Runway project (estimate at €247m in July 2014 prices) given an assumed constant 25m passenger volume.

An appropriate price cap adjustment, is one which allows for full remuneration (including both return on and of investment) of the efficiently incurred costs on a per passenger basis[18].

Seeking to maintain the (total) price cap adjustment at €0.59 for the life of the runway requires a series of ongoing adjustments to the RAB value of the North Runway (this would be incorporated within the volume risk adjustments discussed in the previous section). From the perspective of achieving the objective of remuneration of efficiently incurred capital costs, this is an unwieldly reversal of the standard regulatory approach - CAR are proposing a price cap adjustment and then working backwards to find an appropriate RAB value, rather than first taking the level of efficient cost and from this calculating the appropriate price cap adjustment based on asset life, depreciation policy, return on capital and passenger volume.

An alternative, simpler approach would be to calculate the appropriate price cap adjustment based on the passenger volume out-turn for the year in which the milestone is achieved. As better information on passenger volume will be available as the milestones are achieved, that passenger volume should rather be used to calculate the price cap adjustment. This would negate the requirement for RAB adjustments at the end of each regulatory period.

For example, if Milestone 1 is achieved in 2017 and triggers 10% of the capital allowance (€24.7m), then a more appropriate price cap adjustment in 2018 could be calculated by using 2017 passenger outturn volume rather than adjusting the price cap by €0.06 (a figure which was arrived at using the 2014 'best estimate'). For example, assuming a passenger out-turn of 27.9m, the price cap adjustment would become €0.05 and no further adjustments would be required thereafter (i.e., in the RAB). The difference in these two approaches is demonstrated in Table 2.

[18] Where a price cap adjustment is calculated using a forecasted passenger base, there is potential for remuneration over the life of the project to be greater or less than the efficiently incurred capital expenditure amount, due to passenger out-turn varying from the forecast. However, such variance arises from volume risk not from the initial price cap adjustment calculation, and there is consistent potential for such variance to arise for all assets within the RAB.

Table 2: CAR's proposed approach versus daa's proposed approach

CAR Proposed Approach				daa Proposed Approach		
M1 price cap adjustment - €		0.06		**Allowed remuneration p.a. - €m**		1.5
Trigger pax level - millions		25.0		**2017 pax out-turn - millions**		27.9
Allowed remuneration p.a. - €m		1.5		**M1 price cap adjustment - €**		0.05
2018 & 2019 pax - millions		27.9		**2018 & 2019 pax - millions**		27.9
	Collected	**Allowed**			**Collected**	**Allowed**
2018 Revenues from M1 - €m	1.7	1.5		**2018 Revenues from M1 - €m**	1.5	1.5
2019 Revenues from M1 - €m	1.7	1.5		**2019 Revenues from M1 - €m**	1.5	1.5
Total	**3.3**	**3.0**		**Total**	**3.0**	**3.0**
Over-collection		**0.3**				
RAB (€m)		**2020**		**RAB (€m)**		**2020**
Capital value of M1 unadjusted		24.7		**Capital value of M1**		24.7
Adjustment for over-collection		(0.3)				
Capital value of M1 in Opening RAB 2020		24.4		**Capital value of M1 in Opening RAB 2020**		24.7

Notes: 1. Assumption that Milestone 1 is reached in 2017 with price cap adjustment from 2018
2. To isolate the impact of retaining the €0.59 price cap adjustment from CAR's proposal to reallocate volume risk the calculations in Table 2 assume a constant passenger volume of 27.9m pax in 2017 to 2019.

If daa's approach were adopted, a similar calculation for the appropriate price cap adjustment for Milestone 2 (85% of the capital allowance) and Milestone 3 (the final 5%), utilising the most current passenger volume information, would be undertaken when those milestones were achieved. daa believe this approach would simplify the price cap and RAB adjustments required for the remuneration of the North Runway project.

To summarise, without a clearly defined benefit for maintaining the total price cap adjustment for North Runway at €0.59, and given the level of complexity added, CAR should simply recalculate the appropriate price cap adjustment to remunerate the level of efficient spend incurred. This could easily be achieved by using the best available passenger volume information when particular milestones are reached as the denominator in the price cap adjustment calculation.

5. Replacing single price cap adjustment with three adjustments

CAR has proposed to replace the existing single price cap adjustment of €0.59 which was dependent on achieving 25 million passengers in a rolling twelve month period with three price cap adjustments (totalling to €0.59) based on the achievement of three project milestones.

daa's proposal is that remuneration be aligned to six project milestones. We consider this approach to provide greater benefits to the airport and airlines than CAR's proposal as:

- It would somewhat reduce the very significant swing in regulatory policy from pre-funding to almost wholly post-funding of this investment;
- It would smooth rather than largely simply postpone the spike in price cap representing North Runway remuneration;
- It would protect a minimum investment grade credit rating (BBB) for the regulated entity, and hence a lower cost of debt contained within the WACC, which is the return on investment airlines provide to daa.

5.1 Pre vs Post funding of North Runway

In CP2/2016, CAR states[19] "*at the time of making that [2014] Determination the Commission was of the understanding that Dublin Airport would commence construction on the North Runway in late 2016 per its 2015 – 2019 Capital Investment Plan*". However, on page 181 of daa's CIP 2015-2019 Proposals document, it stated that "*construction commencement for this project* [should] *be linked to* demand triggers". Additionally in section 7 of that document it was reiterated that it would be attainment of the trigger that would make it appropriate to commence construction.

In the 2014 Determination, CAR set the North Runway trigger at 25 million passengers without any explicit statement as to whether this would represent an element of pre- or post-funding of the project. As daa had specifically stated in its Regulatory Proposition that, on attainment of the trigger, commencement of expenditure would be appropriate, we cannot agree with CAR's assertion that the trigger was silent[20] on pre-funding. Rather, pre-funding would have to have been assumed as daa had already indicated its intention to only commence construction on attainment of the trigger. This was a rational approach by daa due to the inherent uncertainty over when the trigger would be reached and to ensure financial security of remuneration[21]. The change from pre-funding to almost wholly post-funding represents a very significant shift in regulatory policy, particularly given that this project has already commenced. While the trigger may have occurred earlier than expected, the actions that are brought forward by the occurrence of the trigger are exactly as expected, hence a change in regulatory policy is not justified.

CAR also mentions that Terminal 2, daa's largest investment to date under price cap regulation, was not pre-funded. While this is superficially correct, there were specific circumstances relating to that investment which differs from those of the North Runway project, such as:

- daa were instructed by the Department of Transport, Tourism and Sport (DTTaS) to build Terminal 2 in May 2005; and
- On 27 October 2009, during the 2009 Determination process, the Minister for Transport directed CAR (under the appropriate Act) to ensure Dublin Airport's financial viability was protected in order to protect policy on a number of items, including the development of Terminal 2.

Therefore, under explicit governmental instruction, daa was obliged to deliver a second terminal at Dublin Airport irrespective of the level of risk to which shouldering the full pre-funding of that investment exposed the daa group. This explicit Ministerial Direction provided a safety net to daa for the level of risk taken on in wholly pre-funding T2; this safety net is not available for North Runway investment.

daa group had to raise significant debt to fund Terminal 2. In addition, a number of group assets (not part of the regulated entity) were sold prior to the 2008 recession which allowed net debt levels to remain at a level which sustained the group's investment grade credit rating. During the recession, the group's credit rating dropped to a low of BBB with Negative outlook. If daa had not made those sales which reduced net debt, the company may have fallen to non-investment grade status (certainly the financial ratios would have been below those indicated for investment grade). So, in that case, the need for pre-finance was only avoided by asset sales at the group level. If the full burden of the Terminal 2 project had been put on the regulated entity business alone at that time, the "notional" credit rating for the regulated entity company would certainly have gone into non-investment grade status. With a non-investment grade credit rating, the regulated entity would have

19 Paragraph 3.6.

20 Paragraph 3.7, CP2/2016

21 As all triggers and associated price cap adjustments end with the regulatory period, to commence construction of such a significant investment prior to the attainment of the trigger and certainty as to the remuneration of the investment would represent a level of regulatory risk which it would be imprudent for Dublin Airport to undertake.

been exposed to much higher interest rates on debt (or even, given the conditions at that time, been unable to access funding at all).

Since the 2014 Determination, the financial viability of the regulated entity is assessed on a stand-alone basis, with reference to a notional credit rating for the regulated entity alone (i.e., separate from that of daa group as a whole), as it was agreed the group should not have to compensate for short-falls in funds for the regulated entity business[22]. CAR, as the Regulator of Dublin Airport as opposed to daa, is not entitled to assume that daa group will divest group assets to support the pre-funding of the North Runway, as occurred to support the funding of T2. We will return to the issue of the financial viability of the regulated entity in section 5.4.

5.2 Status of Milestones

The milestones proposed by CAR allow for only partial annual remuneration of the runway project until all three milestones have been achieved. daa understands CAR's rationale for introducing a number of milestones to (i) incentivise quick delivery of project and (ii) ensure remuneration commences once expenditure has actually been incurred, and the expenditure allows for the project to progress to a new/next stage. However, the initial trigger allowed for full remuneration once the trigger was achieved (a single event which either would or would not occur in the regulatory period), thus providing certainty on the future remuneration profile for this large scale project before significant expenditure was incurred. It is unclear as to whether milestones would be treated in the same way as triggers at the end of a regulatory period, i.e. do they have the same formal status as triggers? Could milestones be reset, or even dropped, together with their associated capital allowance, in the making of the next regulatory determination? The current expected timeline for the North Runway project shows Milestone 1, representing 10% of the allowance, occurring in the current regulatory period whereas Milestones 2 (85%) and 3 (5%) would fall into the next regulatory period. Given that the greatest proportion of expenditure will occur between Milestones 1 and 2 the future status of milestones set in this Interim Review process is necessarily of significant concern to us.

It would be financially imprudent to begin such significant investment, as would be required between Milestones 1 and 2, where remuneration was contingent on attainment of milestones which could be subject to further regulatory change. To do so would expose the company to significant risk as to when and how a large volume of efficient expenditure would be remunerated.

In this respect, it is vital CAR clarifies the legal status of milestones, particularly with regard to whether they could be altered or dropped in the next regulatory determination.

5.3 CAR's Draft Proposed Milestones

Number of Milestones

While CAR is proposing three milestones the capital allowances associated with each are not equivalent. The first milestone allows for 10% remuneration, sharply increasing to 95% remuneration when Milestone 2 is achieved, with the final 5% being added on achievement of Milestone 3 - with full remuneration dependent on achievement of all three milestones. Clearly, the bulk of remuneration would begin once Milestone 2 is achieved.

Additionally, CAR are proposing a similar approach to that of the CAA[23]'s Assets in the Course of Construction (AICC[24]) remuneration approach, by allowing the return element i.e. 'the return on' to

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[22] Or vice versa

[23] Civil Aviation Authority.

cover Milestone 1 capital proportion until Milestone 2 is complete, with Milestone 1 depreciation only entering the RAB on attainment of Milestone 2. This approach has been used at Heathrow on Terminals 2 and 5 and it has also been used in the UK's water sector. This approach allows for some project pre-funding and thereby reduces the risk exposure for the company funding such significant investment. Lower risk exposure can lead to lower financing costs (all else equal) and a lower level of charges for users over time. However, the small number of milestones proposed by CAR does not allow for the benefits of this approach to be fully optimised.

In daa's information note to CAR[25] regarding runway milestones, timeline and expenditure, six runway milestones were given. These six milestones reflect how the expenditure on the project has been / will be incurred, and how a recognisable stage in project completion has been/will be achieved. daa believe at least two additional milestones, if not all three additional milestones as previously suggested, should be introduced to reduce daa's risk exposure and to allow a smoother/more gradual step up in the price cap remuneration for both the company and users. We believe that airlines would support a remuneration profile for North Runway which would avoid or at least reduce sharp spikes in the price path. Smooth pricing derisks the collective interests of airlines by providing clarity and line of sight on the price path for future business and corporate planning. The consumer would also benefit from such an approach, as a smooth price path against a current backdrop of low inflation, allows airlines greater certainty in the selling forward of fares and so reduces the risk premium they would be expected to attach if there was greater volatility in future prices.
daa's suggested milestones and proportionate spend of total €247m allowance are as detailed in Table 3.

Table 3: daa's proposed milestones for North Runway Delivery

Milestone Number	Milestone	Remuneration %	Cumulative %
1	Completion of Construction Package 1	10%	10%
2	Construction Package 2 commences	25%	35%
3	Construction Package 2 50% complete	25%	60%
4	Construction Package 2 complete	25%	85%
5	Commissioning of runway complete	10%	95%
6	Close out of full project i.e. official closing date of house buy-out mitigation scheme reached	5%	100%

If CAR were to extend the approach of Milestone 1 remuneration (allowing return on element into the price cap on attainment of each milestone) to remuneration of Milestones 1 to 4, with entry of the capital proportions associated with Milestones 1-5 into the RAB on attainment of Milestone 5, this would i) lower the risk profile of the project and ii) see remuneration of the runway being implemented in a more gradual manner and would more closely reflect actual expenditure incurred to support and incentivise quick delivery of the project.

Postponement of Price Cap Spike

The North Runway trigger of 25m passengers was reached in 2015 and therefore the €0.59 price cap adjustment should have taken place in 2016. As the 2016 base price cap was €9.87, the addition of this €0.59 would have resulted in a spike of 6.0% on the base. This significant one-off increase to the price cap would have been followed by reductions, as the base price cap is reducing by 4.2% per annum in the current regulatory period. As our stated pricing strategy in the current period is to provide flat pricing to airlines, our preference was not to implement such a volatile price path from

[24] http://publicapps.caa.co.uk/docs/33/CAP%201510%20JAN17.pdf – page 35.
[25] As of 11th November 2016, in response to CAR's information request of 17th October 2016.

2016, but rather await the outcome of this interim review in anticipation of it delivering a more gradual price path for North Runway remuneration. However, as CAR is proposing a move from this 100% remuneration at a single point in time to 10%, 95%, 100%, the proposal is more a postponement of the price cap spike from North Runway rather than an effective smoothing. This can be clearly seen in Table 4 where the impact of price cap adjustments from CAR's three milestone model on the price path is shown across a range of potential base price caps. As the current expectation is for CAR's Milestone 2(which delivers the bulk of remuneration in this model) to occur in 2020, an estimate of the price cap in the next regulatory period is required. The current regulatory period will end with a base price cap of 8.68 in 2019 and we have used this value as one of the potential base prices caps for the next regulatory period; we have also examined the price path where the base price cap is €1 lower and €1 higher than this value. If the base price cap in the M2 price cap adjustment year is €8.68, the CAR proposal would desult in a broadly equivalent spike to the price path from the original treatment (5.7% vs. 6.0%); with a base price cap of €7.68, the CAR proposal would actually result in a **higher** spike to the price path (6.5% vs. 6.0%). Even at a €9.68 base price cap, the M2 spike in the price path will be in excess of 5%.

Table 4: price paths with three CAR milestones

Examples of price path based on CAR milestones			
	M1	**M2**	**M3**
Price cap adjustment	**0.06**	**0.50**	**0.03**
Cumulative		**0.56**	**0.59**

Adjusted price cap on attainment of milestones:				
	Base	**Adjusted for M1**	**Adjusted for M2**	**Adjusted for M3**
Price cap	7.68	7.74	8.24	8.27
Price path		*0.8%*	***6.5%***	*0.4%*
Price cap	8.68	8.74	9.24	9.27
Price path		*0.7%*	***5.7%***	*0.3%*
Price cap	9.68	9.74	10.24	10.27
Price path		*0.6%*	***5.1%***	*0.3%*

If our proposal of six milestones for remuneration of the North Runway were adopted the spike in the price path would be smoothed out rather than simply postponed. This is clearly shown by comparison of the price path in Table 4 with that in Table 5. For a €7.68 base price cap the six milestones approach has a largest adjustment to the price cap of 1.9% vs 6.5% under the three milestones approach. Similar significantly lower single price cap adjustments can be seen in the €8.68 and €9.68 scenarios.

Table 5: price path with six daa milestones

Examples of price path based on daa milestones

	M1	M2	M3	M4	M5	M6
Price cap adjustment	0.06	0.15	0.15	0.15	0.6	0.3
Cumulative		0.21	0.35	0.50	0.56	0.59

Adjusted price cap on attainment of milestones:							
	Base	**Adjusted for M1**	**Adjusted for M2**	**Adjusted for M3**	**Adjusted for M4**	**Adjusted for M5**	**Adjusted for M6**
Price cap	7.68	7.74	7.89	8.03	8.18	8.24	8.27
Price path		*0.8%*	*1.9%*	*1.9%*	*1.8%*	*0.7%*	*0.4%*
Price cap	8.68	8.74	8.89	9.03	9.18	9.24	9.27
Price path		*0.7%*	*1.7%*	*1.7%*	*1.6%*	*0.6%*	*0.3%*
Price cap	9.68	9.74	9.89	10.03	10.18	10.24	10.27
Price path		*0.6%*	*1.5%*	*1.5%*	*1.5%*	*0.6%*	*0.3%*

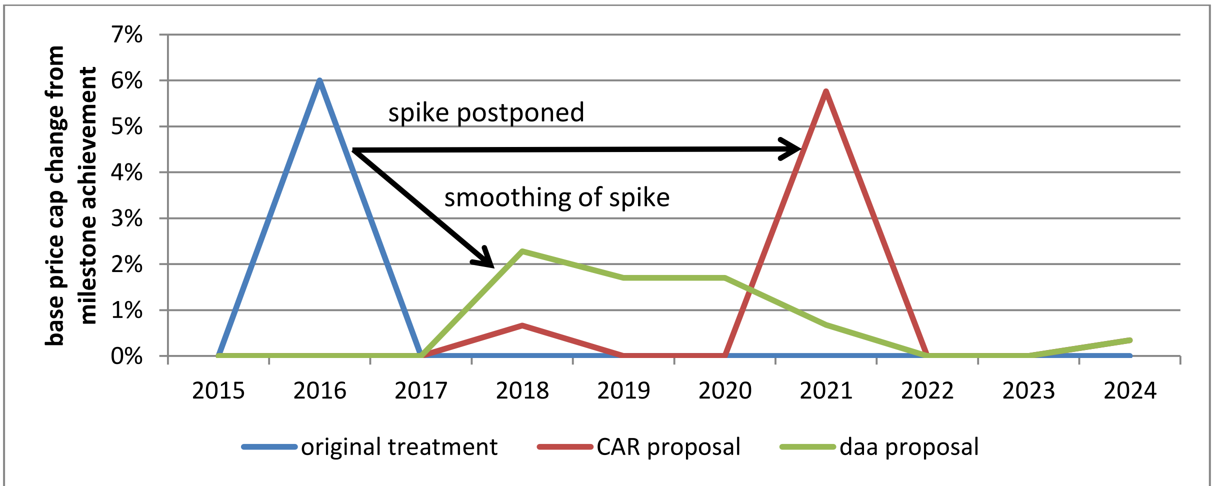
Tables 4 and 5 show the impact of the individual milestones on the price path, but in order to understand the impact of the remuneration of the North Runway in full it needs to be considered **when** these individual milestones will occur.

Table 6: Expected achievement dates for North Runway Trigger/Milestones

	2015	2016	2017	2018	2019	2020	2021	2022	2023
Original treatment	Trigger								
CAR proposal			M1			M2			M3
daa proposal			M1, M2	M3	M4	M5			M6

Based on the current expected timelines for delivery of the North Runway set out in Table 6 (North Runway operationally ready in 2020), Chart 2 illustrates that the three milestone approach to remuneration results in a postponement of the spike in the price path whereas the six milestone approach smooths the impact of North Runway remuneration.

Chart 2: Price Paths under Original North Runway Treatment, CAR Proposal and daa Proposal*



*Note "original treatment" shows impact on actual base price cap 2016 (€9.87); "CAR proposal" and "daa proposal" use actual base price caps for 2018 (€9.06) and 2019 (€8.68) and an assumed base price cap of €8.68 in all other years.

Monitoring of and Reporting on Milestone Achievement

With regard to the three milestones proposed by CAR, and the evidence which they suggest will prove their attainment, we consider for Milestone 1 that signature of contract for the Construction Package 2 be substituted for 'evidence of physical work on site for the main project'. As the contract being tendered is a Design & Build contract, there will be a relatively significant period of time at the start of the contract (3/4 months) spent off-site on the completion of the final design and project phasing plan of the North Runway. A more appropriate milestone point would therefore be contract award as evidenced by the signed contract. For CAR's three proposed milestones we therefore suggest appropriate documentation of attainment as indicated in Table 7.

Table 7: Documentation of Milestone Attainment (CAR's proposed three milestones)

Milestone Number	Name	Evidence of Accomplishment (CAR proposal)	Dublin Airport Proposal for Appropriate Documentation
M1	Main Construction Start	-Receipt of letters of discharge from Fingal County Council for all pre-commencement conditions, -Evidence of physical work onsite for main project, and -Evidence that enabling works are complete.	- Letter of discharge from Fingal CC for all pre-commencement conditions -Propose signed contract for Construction Package 2 as more appropriate milestone indicator -Completion of Works Certificate for Construction Package
M2	North Runway Fully Operational	-Construction and commissioning of the North Runway are complete, -The North Runway is fully operational resulting in additional movements being available for slot allocation, -The North Runway is being used for revenue generating scheduled flights, and -The house and school insulation schemes are complete.	-daa issues Taking Over Certificate -Capacity Declaration for Dublin Airport is based on dual parallel runway operation -Copy of anonymised airline invoice including runway movement charges for movements undertaken on the North Runway -daa letter to Fingal CC stating insulation schemes have closed; Fingal CC acknowledgement
M3	House Buy-out Closure	-Dublin Airport issues formal notification that buyout scheme has closed -Other mitigation measures are complete, and -The Project is complete.	-daa letter to Fingal CC stating house buy-out scheme has closed; Fingal CC acknowledgement -daa letter to Fingal CC stating mitigation measures are complete; Fingal CC acknowledgement

The benefits that can be delivered by a more extensive use of the CAA's Assets in the Course of Construction (AICC[26]) remuneration approach, (offering both financial viability and debt financing costs for the airport and a smoother price path for airlines), could be realised by adopting daa's

[26] http://publicapps.caa.co.uk/docs/33/CAP%201510%20JAN17.pdf – page 35.

proposal of six milestones for remuneration of the North Runway. We provide in Table 8 our proposed documentation evidencing achievement of these six milestones.

Table 8: Documentation of Milestone Attainment (daa's six milestones)

Milestone Number	Milestone	Dublin Airport Proposal for Appropriate Documentation
1	Completion of Construction Package 1	- Letter of discharge from Fingal CC for all pre-commencement conditions -Completion of Works Certificate for Construction Package 1
2	Construction Package 2 commences	-Signed contract for Construction Package 2
3	Construction Package 2 50% complete	-Audited accounts for North Runway project showing expenditure to date on Construction Package 2 at minimum of 50% of total contract value
4	Construction Package 2 complete	-Taking Over Certificate for Construction Package 2
5	Commissioning of runway complete	-Capacity Declaration for Dublin Airport is based on dual parallel runway operation -daa letter to Fingal CC stating insulation schemes have closed; Fingal CC acknowledgement -Copy of anonymised airline invoice including runway movement charges for movements undertaken on the North Runway
6	Close out of full project i.e. official closing date of house buy-out mitigation scheme reached	-daa letter to Fingal CC stating house buy-out scheme has closed; Fingal CC acknowledgement -daa letter to Fingal CC stating mitigation measures are complete; Fingal CC acknowledgement

Remuneration of €247m Allowance in Full

In paragraph 4.6 of CP1/2017, CAR state that the asset life[27] for the proportion of the capital allowance associated with Milestone 3 will be 50 years less X, with X being the number of years which have elapsed between Milestones 2 and 3.

daa would highlight that Milestone 3, which relates to the closure of the house buy-out scheme, will not occur until three years after the runway is operational and further that the operational benefits from the North Runway will be exactly the same on attainment of Milestone 2 as on the attainment of Milestone 3. This condition, that the scheme remains open for three years following the commencement of flight operations from the North Runway, has been agreed with Fingal County Council (FCC). The purpose of allowing the scheme to remain open for a further three years after the commencement of operation is to allow residents to assess the actual noise impact of the North Runway before making a final decision on whether to opt for house buy-out.

As a result, the asset life for the final 5% of North Runway capital allowance proposed by CAR will be 47 years (50 – 3 years) . The CAR proposal will therefore penalise daa for a scheme condition agreed with the planning authority and which does not in any way reduce the operational benefits to be derived from the investment. As CAR has associated a €0.03 price cap adjustment with Milestone 3, which is based on 5% of the 247m allowance over 50 years, allowing Milestone 3 to have an asset life of only 47 years will result in less than full recovery of efficiently incurred costs. The final 5% of North Runway should either be remunerated:

i) from the attainment of Milestone 2 so as to allow full remuneration if the price cap adjustment for Milestone 3 remains at €0.03;
or
ii) by recalculating the price cap adjustment which would remunerate €12.35m (5% of total allowance) over 47 years if remuneration commences on attainment of Milestone 3.

5.4 Financial Viability of the Regulated Entity

daa has assessed CAR's financial viability analysis for the regulated entity to 2019. daa has found a number of anomalies in the analysis such as:

- the exclusion of dividend payments to the shareholder post-2015 [2016 to 2019 period. Per the National Aviation Policy, "*It is Government policy that profitable commercial State companies should pay a financial dividend to the State. The guideline figure is 30% of after-tax profits. The Government expects the State aviation companies to have a clearly stated dividend policy to take account of their current financial circumstances and plans for the future*." Following the receipt of correspondence from the shareholder in relation to their expectations (letter dated 11 April 2016) daa are in the process of agreeing a medium term dividend policy with the shareholder. We expect this policy to be finalised imminently and we will be guided by the NAP, NewERA and shareholder expectations in setting our medium term dividend policy.
- commercial revenues and opex have been flexed for elasticities, however, CAR has used the base year figures of 2013 used in the 2014 Determination. At a minimum, CAR should have used 2015 regulated entity results, flexing those for elasticities, to take account of the change in business revenues and costs following the close out of the 2014 Determination; and

[27] From a scope perspective daa would question if the depreciation profile change is within scope as again, this was not consulted on and substantial grounds were not established to review depreciation profiles for runway remuneration.

- runway expenditure has been under-estimated in the cashflow, with the allowance of €247m used, rather than the more recent estimate of €320m which has previously been communicated to CAR.

Taking account of all the above, CAR's calculated FFO/Net Debt deteriorates as demonstrated in Table 9.

Table 9: FFO/Net Debt calculation with information previously supplied to CAR

	Scenario 1			Scenario 2			Scenario 3		
	2017	2018	2019	2017	2018	2019	2017	2018	2019
CAR's FFO/Net Debt	36.0%	44.0%	54.0%	36.0%	41.0%	47.0%	34.0%	29.0%	25.0%
Revised FFO/Net Debt	32.9%	35.4%	37.9%	32.9%	33.2%	33.0%	31.0%	23.9%	18.8%
Variance versus CAR	**-3.1%**	**-8.6%**	**-16.1%**	**-3.1%**	**-7.8%**	**-14.0%**	**-3.0%**	**-5.1%**	**-6.2%**

Scenario 1 – Traffic growth @ 3% p.a.
Scenario 2 – Traffic growth flat post 2018 i.e. 28.8m pax from 2017.
Scenario 3 – Traffic decline (2017 0%, 2018 -12% & 2019 -8%)

Additionally, there are a number of other factors which must be taken into account in calculating the financial ratios for which CAR would not have daa's current information. These items include:

- an allowance for additional capital expenditure for capacity enhancement projects for which no allowance was made in CIP 2015-2019. CAR has said in CP7/2016, if projects are allowed through the new supplementary capex process, remuneration will begin from the following determination period. There is therefore potential for additional substantial capital expenditure, in addition to that for North Runway, which would have to be pre-funded in the current period[28];
- Runway expenditure profile; milestones do not necessarily correlate with annual expenditure. CAR assumes in years 2017 to 2019 that one milestone will be achieved each year and it is the achievement of each milestone which drives expenditure on the subsequent milestone. This is not the case for the cash-flow profile as daa will be incurring expenditure in advance of reaching milestones i.e. daa could have incurred expenditure relating to more than a single milestone within the calendar year; and
- 2016[29] results should be used as a base to which to apply commercial revenue and opex elasticities for future period forecasts (2017 to 2019).

Taking account of all the above, CAR'S calculated metrics deteriorate further, as demonstrated in Table 10.

Table 10: FFO/Net Debt Updated for 2016 data, Expected Time Profile of North Runway Expenditure and Forecast Additional Capital Expenditure in Current Regulatory Period.

	Scenario 1			Scenario 2			Scenario 3		
	2017	2018	2019	2017	2018	2019	2017	2018	2019
CAR's FFO/Net Debt	36.0%	44.0%	54.0%	36.0%	41.0%	47.0%	34.0%	29.0%	25.0%
Revised FFO/Net Debt	27.9%	25.7%	25.1%	27.9%	24.2%	22.1%	26.3%	17.5%	12.8%
Variance versus CAR	**-8.1%**	**-18.3%**	**-28.9%**	**-8.1%**	**-16.8%**	**-24.9%**	**-7.7%**	**-11.5%**	**-12.2%**

S1 – Scenario 1 – Traffic growth @ 3% p.a.
S2 – Scenario 2 – Traffic growth flat post 2018 i.e. 28.8m pax from 2017).
S3 – Scenario 3 – Traffic decline (2017 0%, 2018 -12% & 2019 -8%)

[28] We have estimated a requirement [redacted] capital expenditure in the current period arising from this process.
[29] Un-audited and not yet published, as of 3 March 2017.

Table 10, which takes account of both anomalies in CAR's initial calculation of daa's financial ratios and current information relating to items which impact on these ratios, demonstrates that the financial ratios as calculated by CAR have been significantly positively overstated. While this is particularly the case for the FFO/Net Debt metric as discussed here, it is also the case for the other financial ratios included in Table A.1 of CP1/2017.

While the FFO/Net Debt is still relatively positive in scenarios 1 and 2, it greatly declines under a recessionary passenger scenario (scenario 3) and in 2019 does not meet the targets set by Standard & Poor's (S&P) for a BBB credit rating.

While the credit rating is not based on the financial ratios alone, the sharp and unheralded changes to regulatory policy[30] added to such sub-optimal financial ratios, could have a negative effect on the rating. While the company may be able to fund operations in the short term, in the event the credit rating dropped below investment grade, it would lead to higher debt costs in the future [2020 Determination] and therefore could directly negatively impact users through a higher WACC. If the WACC were to increase as a result for the 2020-2024 period, the revised rate would apply to the entire RAB which would be an additional cost directly resulting from the delay in commencing runway remuneration.

Table 11 demonstrates that under CAR's recessionary scenario, daa would likely be able to maintain an investment credit rating when runway remuneration spend is excluded. However, if a recessionary scenario were to arise at a point in time when contract commitments were already in place, daa would not have discretion to stop spend. The impact of CAR's proposal in a recessionary scenario, providing as it does for only a minimal level of pre-funding of the runway, is therefore of significant concern to daa; the company's ability to maintain financial ratios would be directly impacted with potential even for a BBB credit rating to be lost.

Table 11: FFO/Net debt metric in Recessionary Scenario with and without North Runway Expenditure

Financial Ratio	S&P BBB Target	S3			S3a		
		2017	2018	2019	2017	2018	2019
FFO/Net Debt	>13%	26.3%	17.5%	12.8%	27.7%	21.6%	17.4%

S3 – Scenario 3 - Traffic decline (2017 0%, 2018 -12% & 2019 -8%)
S3a – Scenario 3 excluding runway expenditure and revenues (through price cap adjustment)

As the impact of Brexit on Ireland and Dublin Airport is unknown at this point, there is considerable uncertainty as to the likelihood of demand loss at the airport in the coming years. It is clear that Dublin Airport's traffic has been more volatile than other airports around Europe over the last number of years with growth and decline rates well above the European averages and, as a result, the company must take a prudent approach when funding significant investments. This is particularly the case where remuneration does not align with expenditure.

Taking all of the above into account, our analysis demonstrates that if CAR were to introduce the additional milestones as suggested in Section 5.3, the additional revenues would not only reduce risk exposure and support a more gradual increase in remuneration for the project (and hence more gradual and smoother price cap adjustments), it would additionally help maintain the regulated entity's credit rating at BBB in a potential recessionary scenario as demonstrated in Table 12.

[30] Referring here both to the reversal of regulatory policy on volume risk and to the significant change to an already agreed remuneration time profile for a project which has already commenced.

Table 12: Financial Ratios in Recessionary Scenario with additional North Runway milestones

Financial Ratio	S&P BBB Target	S3b 2017	S3b 2018	S3b 2019
FFO/Net Debt	>13%	26.3%	18.0%	13.7%

S3b – Scenario 3 and includes additional revenues based on daa achieving daa Milestones 1 and 2 in 2017 and therefore entering price cap from 2018 (35% remuneration) and achieving daa Milestone 3 in 2018 therefore with Milestones 1,2 & 3 being remunerated from 2019.

A further factor for consideration is the stability of the regulatory regime under which Dublin Airport operates, which is taken into consideration by the financial markets which daa seeks to raise finance. CAR clearly in the 2014 Determination that once the trigger of 25m passengers in a 12 month period was achieved funding of the North Runway would commence. In changing this decision (particularly after the project has commenced), the regulatory environment is made unpredictable/unstable and sends out a negative message to bond markets and others sources of debt financing. These funding sources rely on regulation as a key credit factor when assessing if and on what terms to lend to daa, who is critically dependent on such funding sources to be able to invest in critical infrastructure for airport users. This messaging of regulatory stability is also currently being impacted by the outstanding DTTaS/Indecon review of regulation and discussions of an independent third terminal which could also impact investor sentiment. It is important that CAR consider the current level of uncertainty with regard to the future commercial environment for Dublin Airport (i.e., with reference to both the review of the regulatory regime and the assessment of options for the operation of a third terminal at the airport) in assessing whether its proposals on timing of North Runway remuneration and volume risk will have a negative impact on key messaging on regulatory stability. In this regard, as previously stated, clarity on the legal status of milestones will also be required in order to demonstrate regulatory certainty on conditions relating to future cash flows at Dublin Airport.

6. Outturn Cost Reconciliation – Treatment of Variance to Allowance

In CP6/2016, CAR did not find substantial grounds to review the efficient cost of the runway at that point in time, as there was still a material level of uncertainty around final project spend until the main tender process has been completed (a stage in the project which has not yet occurred). Therefore the current 50/50 risk sharing mechanism, implemented in the 2014 Determination for project cost outturn variance to capital allowance, remains in place at this point in time.

From CP1/2017, we welcome CAR's recognition that "*outturn expenditure for the North Runway may be higher than the €247m allowance set in the 2014 Determination*[31]" and that therefore the 50/50 risk sharing mechanism "*comes with risks, for example, for large potential overspends on the project it may not be feasible for Dublin Airport to proceed or on the other hand an unknown cost may be passed on to users without proper consultation or consideration of the benefit*.[32]" The €247m cost estimate was prepared in 2013, at a very low point in the construction sector. Since then the construction sector has recovered to a significant extent. While such recovery is to be welcomed, it is expected, unfortunately, to translate to higher tender returns than were estimated to be achievable from competitive tender in 2013. Additionally, EASA requirements for aerodrome design and operation, together with other regulatory requirements e.g., environmental, have evolved since the preparation of the 2013 cost estimate and this will also be reflected in the final cost outturn for the project.

[31] Paragraph 6.1
[32] Paragraph 6.2

Therefore, we welcome that in CP1/2017, CAR has set out what it would consider the appropriate steps for daa to undertake in order to change the North Runway capital allowance from the current €247m level, with different steps appropriate for different drivers of any cost changes. We consider that the broad thrust of CAR's proposal – consultation and/or independent assessment of outturn costs (either by CAR or third party) as appropriate to the cost driver – should deliver a robust approach to determining the level of expenditure which represents efficient delivery of the North Runway.

Paragraph 6.9 states "*Where the cost change is driven by regulatory change or the cost of materials for example this [reaching of consensus with users] would not be necessary*". With respect to cost drivers for materials, due consideration must therefore be given by CAR to the current level of economic activity in the Dublin region, and the impact this is having on CPI (Construction Price Inflation), the availability of bidders for North Runway tenders and subsequent competition for such tenders. With regard to cost changes driven by regulatory change we contend that certain elements of this cost driver are not suitable for consultation, even to the extent of consultation on available options. For example, the current estimated cost of North Runway at €320m includes a cost for noise insulation and other mitigation schemes. The exact nature of these mitigation schemes is currently being determined through engagement with Fingal County Council (FCC) and the affected community – the outcome of this regulatory requirement is that which satisfies the regulatory authority (in this case FCC) and it would therefore not be feasible to present options for regulatory compliance to users in consultation.

daa is concerned with CAR's suggestion that, where scope changes are non-regulatory, users representing 80% of traffic need to be in agreement for the cost of that change to be remunerated[33]. Where scope changes drives additional spend, they also create benefits for both the airport and airlines. Under the current 50/50 risk sharing mechanism, airlines would only have to remunerate 50% of such additional spend rather than 100% (if they were to agree to the change in consultation). This approach opens potential for perverse incentives and regulatory gaming – airlines could signal non-support for scope changes where the cost/benefit is such that they consider it likely that daa would proceed with the scope change in any event. In this way, airlines would have an incentive **not** to support scope changes with net benefits, as they would only be required to remunerate 50% of the expenditure under the current approach rather than 100% if they signalled support.

daa believe consultation with users will demonstrate that the benefits of non-regulatory scope changes will accrue for both parties and rather than airlines representing 80% of traffic determining the outcome, CAR should determine whether the scope change represents efficient capital spend, based on the evidence provided to support such a change. This would support CAR's objectives i.e. "*to facilitate the efficient and economic development*… and *to enable daa to operate and develop Dublin Airport is a sustainable and financially viable manner*" by ensuring all efficiently incurred capital is remunerated and also close off a window of opportunity for regulatory gaming.

Furthermore, we have seen from the interim capex consultation process (used in the 2010-2014 regulatory period) that it is virtually impossible to get unanimous approval from airlines for capital investment. Given that projects which deliver benefits to the airline community as a whole may provide different levels of benefit to different airlines, even the requirement to achieve approval from airlines representing 80% of traffic may also prove difficult, if not impossible. Again, we contend that the decision to remunerate non-regulatory required scope changes should be based on an objective assessment of the business case for such changes.

[33] Paragraph 6.9 of CP1/2017.

7. Concluding Remarks

The North Runway is a very significant capital investment for Dublin Airport and its future development and success. Given the size of the investment it is necessarily also of significant concern to our airline customers. Conscious of this concern, we have sought to bring forward this project, and the means by which it will be remunerated, in a positive and constructive manner. This is demonstrated by our decision not to price in the €0.59 price cap adjustment from 2016, as would have been expected under the 2014 Determination. In responding to this public consultation on the regulatory treatment of the North Runway we have sought to ensure that the final decision will allow for:

- A smooth price path to be offered to airlines. This can be achieved through the adoption of a larger set of milestones for project remuneration.
- The continuation of regulatory certainty, given its importance in setting expectations in the debt market and hence impact on the cost of debt for the regulated entity. For this reason, amongst others set out in Section 3, we reject the proposal for volume risk on the project to be transferred to airlines.
- A readily understandable system of RAB and price cap adjustments to accommodate the project. This can be more easily achieved if i) the proposal to transfer volume risk is not pursued and ii) price cap adjustments are based on latest available passenger information rather than maintaining the €0.59 adjustment from the 2014 Determination.
- The retention of an investment grade credit rating for Dublin Airport, with concomitant benefits to airlines arising from the lower cost of debt investment grade entities can obtain. Again, a larger set of milestones is therefore proposed. This has been demonstrated to have a positive effect on the financial ratios of the regulated entity and to support the retention of an investment grade credit rating even in a recessionary scenario similar to that experienced in 2009/2010.

We require confirmation as to the future status of milestones for this project, in subsequent regulatory periods, where they are yet to be achieved by current period end.

We welcome the further clarity provided on potential future reassessment of the capital allowance for the North Runway. Under economic regulation, all efficiently incurred capital expenditure should be remunerated; costs arising from a competitive tender process represent efficiency in capital expenditure and thus should be eligible for remuneration. CAR has recognised that changes in material costs may not be suitable for i) consultation or ii) the 50/50 risk-sharing mechanism currently in place. With regard to cost changes arising from regulatory requirements we discussed why, in some cases, it may not be feasible to consult on options to fulfil the requirements e.g. in the detail of the mitigation schemes. With regard to scope changes which are not driven by regulatory requirements we consider that the current proposal, requiring support for airlines representing 80% of traffic, has the potential to give rise to regulatory gaming and so should be reconsidered.

We ask CAR to consider all elements of this submission in framing their final decision for the runway remuneration and future consultation requirements in relation to the North Runway.