COMMENTS FROM AER LINGUS ON OTHER SUBMISSIONS TO CP2/2005

Having reviewed the various submissions made to CAR's Draft Determination (CP2/2005), Aer Lingus wishes to make a number of comments on the submissions made by the Dublin Airport Authority. Nothing contained in DAA's response leads Aer Lingus to change its views as set out in our own submission to the Draft Determination. This brief note sets out some additional comments prompted by DAA's response. Failure to comment on any aspect of DAA's submission should not be construed as agreement with DAA's position but rather indicates that our position on that subject is unchanged from our earlier submission.

As a general comment, we strongly disagree with DAA that CAR's Draft Determination is too tight and places excessive risks on DAA. On the contrary, we believe that the Draft Determination is insufficiently challenging in the area of operating costs and allows for a capital investment programme which is characterised by:

- inadequate specification of the outputs of that investment;
- a lack of protection for airport users in terms of binding service level agreements; and
- insufficient consideration of how the investment programme can be efficiency funded.

1. Scenarios

DAA seems to reject all of CAR's scenarios, although it notes that scenario 4 is most internally consistent. We have also expressed our reservations regarding these scenarios, although our conclusions are diametrically opposed to those of DAA.

DAA dismisses scenarios 1 and 2 as internally inconsistent because these scenarios include traffic growth without the costs of accommodating that growth. We recognise that there is some truth in this, but DAA misses the point that these scenarios represent a baseline for opex and capital maintenance before considering the impacts of capex to meet growth. As such, these scenarios are revealing in that they show CAR to be excessively generous to DAA. In particular, there is insufficient evidence of CAR setting DAA challenging targets for opex efficiency, which we believe are justified given DAA's current inefficiency and the duty of CAR to promote productive efficiency.

Furthermore, we strongly disagree with DAA's suggestion that CAR cannot include assumptions regarding efficiencies from the start of 2005. It is CAR's responsibility to press DAA continuously for further efficiency improvements. The exact detail or source of these improvements is not relevant. It is reasonable for CAR to assume that efficiencies can be achieved, and leave

DAA to determine how best to achieve them. DAA's objections in this regard are particularly ironic given that in its response on benchmarking (p. 7) it boasts about the ongoing productivity gains that it is achieving.

2. Cost of Capital

CAR is aware from our earlier submission that Aer Lingus considers the WACC of 7.4% proposed in the Draft Determination to be too generous. We see no reason whatsoever to give consideration to DAA's suggestion that the WACC should be even higher, let alone 8.5%.

As we have outlined, we believe that there is significant scope for DAA to finance much of its growth capex using limited recourse debt to finance specific projects. As a consequence the marginal cost of capital on growth investment should be significantly lower than DAA's WACC on its existing assets.

The Nera paper attached to DAA's submission argues that the cost of capital is significantly higher than the estimate obtained by the CAR's advisers. Aer Lingus does not believe that the Nera analysis for DAA is correct. In particular, we would like to draw attention to the following.

- Equity Risk Premium (ERP). As we have previously submitted, an ERP figure of 6% is too high and not consistent with all of the available evidence. We agree with Nera that the Dimson, Marsh and Staunton dataset is the most robust source of historical data on the ERP. This shows that historic ERP on a selection of the world's leading equity markets over the period 1900-2002 was 3.8% on a geometric basis and 4.9% on an arithmetic basis. The authors themselves recommend a forward looking ERP of 5% which we believe is an appropriate figure. We also note that Nera have been selective in their use of regulatory precedent. They argue strongly that the UK regulatory precedent on the risk-free rate should be taken into account but they do not mention the UK regulatory evidence on the ERP which supports a figure at or below 5%.

- Beta. The Nera paper argues that there is a calculation error in the Kearney and Hutson analysis which increases the estimate of BAA's asset Beta slightly above 0.5 over the past four years. We are not in a position to comment on the validity of this comment but we believe that there is no reason to apply an asset Beta value of much above 0.5 to DAA. We believe that BAA is an appropriate comparator for DAA with a similar risk profile. The Nera paper cites the 2002 UK Competition Commission assessment in support of their view. This assessment used an asset Beta of 0.68. However, it is important to consider the Commission's view on Beta in the context of their view on the other parameters. The Commission applied an asset Beta of 0.68 to an ERP of 3.5%. This gives an (unlevered) risk premium for BAA of 2.38% (i.e. 0.68 x 3.5%). We believe that a risk premium of 2.5% (0.5 x 5%) is appropriate for DAA, a small uplift on the premium applied to

BAA. The Nera analysis suggests a risk premium of 4.2%, implying that DAA is nearly twice as risky as BAA. Nera do not provide any justification for this additional premium. Our understanding is that BAA has had no difficulty in raising finance at the level set by the Commission.

3. Financial viability

We do not agree with DAA's view that it must necessarily maintain an "A" credit rating, given that other regulators have considered that a minimum investment grade of "BBB" was sufficient for price regulated companies. Nonetheless, we believe that DAA is substantially overstating the impact of higher gearing on its credit rating if it were to adopt a properly imaginative approach to its funding issues.

We note that DAA argues that CAR is wrong to use the ratio of FFO to debt over a five year period as a financial constraint and that it should rather employ the annual ratio. We disagree strongly with this suggestion. On the contrary, we believe that the protection afforded DAA by price regulation means that the FFO to debt ratio is unimportant, provided the company can demonstrate adequate cash flow ratios. It appears from CAR's analysis that this is the case, hence we see no need for DAA's price limits to be adjusted for financial viability reasons.

Finally, we note on p. 6 that DAA is asking for protection against risks relating to the variation in opex and commercial revenues. These are normal commercial risks for which no regulated company can expect protection. Furthermore, these risks are already reflected in the estimated WACC.

4. Pensions

As indicated in our original submission, DAA is a member of a multi-employer pension scheme (Irish Airlines (General Employees) Superannuation Scheme), the other members of which are Aer Lingus and SR Technics. The contribution rates payable by the employers and the employees are both fixed at the rate of 6.375% of salary and there is no obligation on either employers or employees to vary those contributions regardless of the actuarial position.

Aer Lingus does not disagree with the proposition that reasonable pension costs should be funded through the regulatory mechanism. However, the DAA submission refers to a proposed increase in the funding rate and also an intention to establish a new pension scheme. We assume the increased funding rate arises through the establishment of some form of new scheme as it is not possible, within the terms of the existing multi-employer scheme, for any one employer to increase its contribution rate and to ring fence this for the benefit of its own employees. Furthermore, any such increase, however implemented, would be an enhancement to current scheme rules and, as indicated in our original submission, should not be paid for by DAA's customers.

We also note that DAA's submission refers to the treatment of actuarial deficits. As indicated in our original submission, the current multi-employer scheme does not guarantee CPI indexation - increases in pensions are at the discretion of the trustee and are considered annually. The last actuarial valuation confirmed that there was no actuarial deficit in the scheme - a deficit only arises if indexation is assumed, which would be an enhancement to the current scheme. For the reasons already outlined, we do not believe customers should pay for any such enhancements.

Finally in this regard, we note that DAA agrees with our view that if there were any additional pension costs they should be recovered through operating charges rather than through the RAB.

5. Capex

Aer Lingus accepts that significant investment is required to meet growth at Dublin Airport. Our issue is not with this fact, but rather with the quantification of that investment, the precise specification of the outputs that will be provided and the way in which this investment should be funded.

CAR will be aware that Aer Lingus considers that much more work needs to go into defining the exact specification of that investment before exact figures can be defined. Also, we believe much more creative use of project-based limited recourse debt finance should be used, instead of capitalising all investment in the RAB.

We note that DAA refers to the consultation it has undertaken in defining its plans. Historically, the airport authority has not engaged in meaningful consultation with its users. This new process has only just commenced and is at the very early stages. Aer Lingus is willing to participate fully and constructively in this process. We repeat our suggestion that this should be a tripartite process between CAR, DAA and users to ensure that genuine consultation takes place and that all capital expenditure meets the needs of current and prospective users of the airport.

6. RAB

DAA argues that capitalising actual investment in the RAB, rather than allowed investment is economically efficient and in line with regulatory precedent. We strongly disagree. Capitalising actual investment is only efficient in a strictly static sense of equating prices with actual costs. In competitive markets firms cannot however charge according to the costs they incur, as prices are set in the market by those firms that have incurred an efficient level of costs. To create the appropriate incentives for dynamic efficiency, DAA similarly needs to have the discipline of acting within an externally applied constraint. Without that constraint there would be nothing to stop DAA "gold-plating" its investment in the airport in the certain knowledge that anything it spent would be remunerated.

There are examples of regulatory schemes that capitalise actual investment into the RAB, but in our view these are demonstrably bad regimes, as they neither encourage cost efficiency, nor a focus on the needs of customers.

We furthermore do not accept that economic efficiency considerations require CAR to include "imprudent" investment in the RAB. As we outlined in our original submission, competitive markets do not allow companies to recover the costs of imprudent investment. Furthermore a company's cost of capital includes compensation for such risks. To return imprudent investments to the RAB would be to send quite the wrong efficiency signals to DAA. We also disagree that disallowing investment sends the wrong signal to investors. On the contrary, it sends exactly the right signal: DAA must invest wisely on assets that are needed. We also consider that dynamic efficiency is promoted by excluding this investment. We note that DAA say (p. 31) that "this may strongly discourage *similar* investment in the future" (emphasis added). Surely this is exactly the point! DAA must be incentivised not to make similar imprudent investments in future.

Finally, we are concerned that DAA think that the RAB should not be adjusted downwards to reflect the value of investment on Pier D that was funded in the previous period, but never spent. This is a routine regulatory measure and, we believe, necessary in this case to ensure that the airlines do not pay twice for the same facilities.

7. Quality of service

We do not accept DAA's proposal that CAR "adopts the performance targets agreed between the airport authority and airline users as part of the existing voluntary service level agreements".

This proposition is inadequate for a number of reasons. First, it fails to deal with the regulation of the outputs of the new investment to expand capacity. The service level associated with these new investments needs to be specified, so that CAR will be in a position to ensure that the airlines are getting what they have paid for. Secondly, mere publishing of performance measures does not ensure that DAA meets them, in the absence of effective penalties for poor performance. It is our experience that DAA has to date failed to meet its obligations under the existing voluntary agreements. This is why we believe DAA must be subjected to new binding SLAs, with clear and adequate penalties for failure.

8. Benchmarking costs

Aer Lingus supports CAR's conclusion that DAA has significant scope to improve its efficiency. We agree with CAR that this is the correct conclusion to be drawn from the TRL and ATRS comparative studies.

However, we reiterate our view that CAR has been insufficiently bold in setting DAA opex targets for the next regulatory period. The figures derived by BAH seem to be insufficiently challenging, while the opex figures

contained in the modelling scenarios appear to demonstrate little or no productivity improvement in practice.

We therefore ask CAR to look again at these figures with an eye to tightening significantly the opex targets that DAA is expected to achieve over the next five years.