

OBSERVATIONS OF AER LINGUS ON THE DECISION OF THE AVIATION APPEAL PANEL

A. Off-Peak ‘Landing and Take Off’ Charges and Aircraft Classification

There was a large degree of consensus in the various appeals that it is not appropriate to base the charges for off-peak take off and landing charges at Dublin Airport on the ACN classifications. Indeed, even Aer Rianta did not contest this issue in its observations. The shortcomings of the Commission’s decision in this regard are set out in detail in the various appeals and we would restate the arguments set out in those submissions as summarised in the Appeal Panel’s decision. For the reasons outlined therein, we would submit that the aim of incentivising off-peak usage can be achieved in a more equitable and non-discriminatory manner by applying a reduced charge per tonne based on the certified MTOW of each aircraft.

B. Efficiency

The Appeal Panel found that sufficient grounds have been established to request the Commission to consider setting more demanding efficiency improvement targets for all three airports. In particular, the Panel has requested the Commission to reconsider the need to reduce relative efficiency levels with peer airports more rapidly (reflecting the reality of more competitive markets) and to allow for economies of scale and technical improvements that should arise as the airports expand and develop. The Panel also expressed concern that the modest efficiency target of 4% set for Shannon did not even meet the Commission’s own objective of reducing the existing efficiency gap with peer airports by half during the period of the Determination.

Aer Lingus wishes to make a number of further observations in relation to the appropriate efficiency improvement targets which should be set by the Commission. In particular, the following comments will address (1) the Commission’s choice of comparator airports, (2) the speed and degree of convergence to the efficient frontier and (3) economies of scale and technical progress. Finally (4), we have summarised the effect which appropriate adjustments to these various components would have on the Commission’s Determination.

(1) The Commission’s Choice of Comparator Airports

(a) Commission’s Methodology

In its benchmarking report prepared for the Commission, IMG used data from a number of comparator airports to determine the efficient benchmark. The Commission relied on this data to establish the applicable efficiency frontier. The following should be noted in relation to the methodology adopted by the Commission:

➤ Dublin

- the most efficient comparators in the sample - the three U.S. airports - were excluded;
- the Commission then used an average of the best five European airports.

The Commission's efficient frontier for Dublin is in fact composed of an average of the fourth, fifth, sixth, seventh and eighth most efficient airports, from a sample of thirteen airports. Consequently, the "efficient unit opex" benchmark so obtained is 52% higher than that of the most efficient airport in the European sample and 173% higher than the most efficient airport in the sample.

➤ Shannon (and Cork):

- the "efficient frontier" was found by averaging across three airports from the sample of eight, including the two Irish airports.

Both benchmarking exercises have therefore compared the three Irish airports with an average and not with best practice. However, the aim of benchmarking should be to identify best practice (the "efficient frontier"). Clearly, best practice will not be represented by the average of a sample that includes inefficient comparators.

(b) Review of Regulatory Best Practice

The Commission's methodology in establishing the efficient frontier is inconsistent with the practice of regulators in the United Kingdom engaged in benchmarking exercises. It is important to note in this regard that the estimation of efficiency is not a statistical process in which there may be random errors that need to be smoothed by averaging¹. Thus, small sample sizes are not in themselves a problem. A benchmark based on the absolute best performer is only inappropriate if there is some specific reason to believe that the best performer is not a valid comparator.

Regulators in the United Kingdom and elsewhere have generally used the best companies, rather than an average of a sample, to set efficiency benchmarks. This approach is clearly illustrated by following examples:

- Although the MMC and CAA have never carried out an explicit benchmarking exercise comparable to that carried out by the Commission², MMC reports setting airport charges do refer to differences between pairs of the four airports under consideration. For example, the MMC carried out regression analysis of staffing levels at BAA's airports in its 1996 review³. Similarly, Manchester's total costs and operating expenditure were explicitly compared to those of other airports, particularly Gatwick in the 1997 MMC review⁴.

¹ There may be smoothing required when engaged in total cost benchmarking (because capital expenditure profiles are cyclical) but this should not affect an opex-only benchmark.

² Not least because the airport operators' own submissions usually include significant efficiency savings, placing less onus on the regulator to force such improvements compared to the Commission's task. For example, in the 1996 MMC report on BAA's price control, BAA itself projected 4% annual improvements in passengers/staff ratios for LHR, LGW and LAL and 6% for STN. In the previous review, Manchester Airport had projected a 47% overall increase in labour productivity. As far as we are aware, ART has not made any similarly reasonable proposals in this process.

³ *BAA plc. A report on economic regulation of the London airports companies* (MMC, June 1996).

⁴ *Manchester Airport plc. A report on the economic regulation of Manchester Airport plc.* (MMC, July 1997).

- In OFGEM's price control review of the electricity distribution companies in Britain⁵, benchmarking was used to determine efficient opex levels. The benchmark was set by the performance of just two efficient companies out of the fourteen distribution companies.
- OFWAT has a well-established methodology in which statistical analysis is used to determine the average relationship between cost drivers and cost levels but the resulting line is then shifted to the position of the single most efficient company⁶. Thus, although 28 companies were included in the analysis in the 1999 price control review, the efficient benchmark was set by the performance of the best of these 28⁷.

The apparent decision by the Commission to exclude Cork from the peer group used to set Shannon's price control is also not supported by international regulatory practice. It is quite common for several entities owned by the same party to be used to benchmark one another. For example, in the United Kingdom several of the electricity or water networks in the two benchmarking exercises described above were under common ownership⁸. In certain cases, the inclusion of several commonly-owned operations is essential. For example, Transco's regional operations were benchmarked against one another in OFGEM's last price control review of this gas transportation company.

(c) Conclusion

In view of the above, Aer Lingus submits that the Commission should use the best comparator within each peer group in setting the efficiency targets for Dublin and Shannon. We note that this same approach would result in Cork being found to be slightly less than 100% efficient.

Since the most efficient comparator in Europe for Dublin is Copenhagen, which handles about 40% more traffic than Dublin, there is a link between this issue and the problem of accounting for economies of scale. We discuss this later in paragraph (3)(i) below. If, as in the original determination, the Commission acts as if economies of scale are not significant, then there is no reason not to use Copenhagen as the principal benchmark for Dublin.

(2) Speed and degree of convergence to the efficient frontier

(a) Commission's Methodology

Dublin and Shannon were found to be inefficient by the Commission. In each case, the Commission stated that their charges would be capped on the assumption that half of this measured inefficiency would be eliminated by the end of the price control. These required cost reductions would be implemented in equal annual percentage reductions in unit opex, set at 3.5% p.a. for Dublin and 4% p.a. for Shannon.

⁵ *Reviews of Public Electricity Suppliers 1998 to 2000 Distribution Price Control Review. Final Proposals.* (OFGEM, 1999)

⁶ This technique is known as Corrected Ordinary Least Squares (COLS) regression.

⁷ *Final determinations: Future water and sewerage charges 200-05* (OFWAT, 1999).

⁸ For example, Scottish Power owns Manweb in England and its own network in Scotland. The two were included as separate comparators in the benchmarking for OFGEM's 1999 price control review.

As previously stated in our appeal submissions, the 4% annual reduction for Shannon does not appear to achieve even the Commission's insufficient requirements for efficiency improvements. To achieve the Commission's stated target of halving Shannon's 50% inefficiency by 2005, the annual reduction should be 5.6%. We assume that this inconsistency at least will be addressed in the revised decision.

However, even if accurately implemented, a requirement to converge only half-way toward the target for efficient costs is insufficiently demanding⁹ and will result in airport users continuing to subsidise Aer Rianta's inefficiency. For example, the Commission found in relation to Shannon that its airport costs per Workload Unit are more than twice as high as they should be. At present, therefore, half of the opex component of the charges users pay Aer Rianta to use Shannon serve to fund Aer Rianta's inefficiency and only half actually represent the efficient cost of providing services. If, as has been proposed by the Commission in its Determination, the price control were set so that half of this inefficiency were disallowed by the beginning of year five of the price control (an annual reduction of 5.6%) then the total charges paid for opex by Aer Lingus or any other user over the five years of the price control would still be about 70% higher¹⁰ than they would have been if Shannon were run by an efficient operator. This is totally unacceptable.

(b) Review of Regulatory Best Practice

There are strong regulatory arguments for all inefficient costs to be disallowed immediately. This will not damage the ability of the regulated business to finance its continuing activities if inefficient costs are rapidly stripped out as they should be under incentive-based regulation. A firm not in financial distress should be able to cope with a temporary period of returns below the cost of capital by increasing gearing. Raising funds for new investment should not be a problem even if some continuing costs are disallowed as the cost of capital is a forward-looking concept and the cost of raising funds for investment is unrelated to the firm's current cashflow. Aer Lingus made this point in its submission in response to the Commission's Consultation Paper CP2/2000.

Without prejudice to this position, we acknowledge that it is likely at this stage that the Commission will allow Aer Rianta to recover its expected operating expenditure during a period of convergence towards efficient cost. This convergence period should, however, be brief and the path to efficiency set at the maximum possible rate at which it is reasonable to expect a well-run business to reduce expenditure, once it has been shown to be inefficient. We are not aware of any precedent where a regulator's starting position, having identified inefficiency, is to allow a significant proportion of that inefficiency to remain by the end of the price control period. The following examples should be noted in this regard.

- Previous CAA/MMC decisions regarding airports in the UK have never identified inefficiency to the extent that Aer Rianta has been found to exhibit at Dublin and Shannon airports. Instead, attention has sometimes focused on detailed "bottom up" comparisons of the costs of specific services. For example, the MMC in 1997 considered a comparison of the staff costs in Manchester and Gatwick Airports, taking into account organisational differences in handling various activities. After

⁹ Even before considering that this target is based on year 2000 costs (see discussion of economies of scale and technical progress) for a sample that does not represent best practice (see sample selection discussion above).

¹⁰ Whether calculated as a net present value or undiscounted sum.

these adjustments, staff costs per passenger were estimated to be almost 10% higher at Manchester Airport than at Gatwick. The MMC set a target to eliminate this gap.

- OFGEM’s initial proposals in 1999 for electricity distribution price controls (referred to above) were for 100% of benchmarked opex inefficiency to be eliminated by the end of the five-year price control period. Subsequently, this target was revised to eliminate 75% of inefficiency three years into the price control. We note that this revised proposal was actually tougher than the first (the NPV of the more rapid reduction, over the five years, was only 95% of the NPV of the original proposal). The fastest required rate of opex reduction was 6.2%.
- Dte, the energy regulator in The Netherlands, required all measured inefficiency to be eliminated in separate reviews of electricity distribution, electricity transmission, gas distribution and electricity and gas supply in recent reviews. The only constraint related to the speed of cost reduction: total costs were not expected to fall by more than 8% annually, within which opex was not expected to fall by more than 10% annually¹¹.

(c) Conclusion

Aer Lingus believes that, given the high measured inefficiency at Dublin and Shannon, a “target inefficiency” level should not be set at all. Rather, the Commission should feel constrained only by the maximum reduction in annual opex that it could reasonably expect Aer Rianta to achieve.

It is easier to reduce costs the more inefficient a business is. There are obviously some easy wins to be achieved by a company which is substantially inefficient, while a company already close to the efficient frontier will find it harder to make further savings. Privatised industries in the United Kingdom mostly experienced such easy wins in the years following privatisation, as they were subjected to incentive regulation for the first time. Aer Rianta, although still in public ownership, should be expected to achieve similar performance now that it is subject to an incentive-based regulatory regime¹².

Table 1 below provides estimates of changes in Real Unit Operating Expenditures (RUOE) in the privatised industries in the United Kingdom in the period after privatisation. It also provides the Compounded Annual Growth Rate (CAGR) in RUOE over the period.

¹¹ *Guidelines for price cap regulation in the Dutch electricity sector (network and retail)*, (Dte February 2000).

¹² We note that the very first price controls on regulated privatised industries in the UK invariably underestimated the effectiveness of incentive regulation and the degree of cost reduction that would be achieved. The consequence was high profits and public dissatisfaction, leading ultimately to a reversal of initial price controls (and the Labour Government’s “windfall tax”, which included BAA among many utilities believed to have achieved excess profits as a result of lax regulation).

Table 1: Reduction in RUOE in privatised industries

Company/Sector	Period	Overall change	CAGR
British Airports Authority	1987-1999	-15.9%	-1.6%
British Airways	1987-1999	-26.6%	-2.5%
British Telecom	1984-1999	-25.5%	-4.8%
British Gas	1986-1995	-50.2%	-7.5%
Transco	1996-1998	-30.1%	-16.4%
Electricity Transmission	1991-1998	-38.8%	-6.8%
Electricity distribution	1991-1998	-37.7%	-6.5%
Sewerage	1989-1998	-17.7%	-4.1%
Water	1989-1998	-15.9%	-3.7%

Source: OFWAT/Europe Economics and ORR/Europe Economics

Table 1 above shows that privatised industries have been achieving substantial reductions in RUOE over a long period of time. However, it is not the average that matters when considering the maximum rate of productivity growth that can be achieved, once inefficiency has clearly been identified. Rather, experience in the United Kingdom illustrates that far more rapid cost reductions can be achieved in a short period. For example, BAA achieved annual opex reductions of over 10% in 1989 and almost 15% in 1993¹³. Similarly, Manchester Airport reduced operating expenditure per passenger by almost 13% between 1992/93 and 1993/94. It should also be noted in this regard that Aer Lingus' restructuring plan which was drawn up subsequent to 11 September provides for annual cost reductions of €200 million and is to be implemented by end of March 2002.

In view of the above, the Commission should take a reasonable view on the maximum rate of achievable cost reductions. Given the high inefficiency found by IMG, Aer Lingus submits that it would be unreasonable to propose a limit on annual opex reductions lower than 10% for a moderately inefficient company, or 15% for a highly inefficient company.

(3) Economies of Scale and Technical Progress

(a) Economies of Scale

It is not clear whether the Commission incorporated the effects of economies of scale in its Determination. It is well accepted that in some businesses, volume growth does not result in a one-for-one increase in costs. It is also clear that airports are just such a business. However, in the Commission's Determination, operating expenditure was assumed to rise one-for-one with increasing passenger numbers. This is particularly clear at Cork, which was set a zero opex productivity target, despite being forecast to achieve passenger growth of 30% over the period.

In effect, although Dublin and Shannon are required by the Commission's Determination to converge towards efficient operating expenditure levels (and Cork is already essentially there), these targets represent only the unit cost levels achieved by comparators in 2000.

¹³ There is a clear regulatory cycle in BAA's costs: costs increase before a price review and then decrease rapidly following the regulator's decision. This is a common phenomenon in regulated industries and illustrates the need for regulators to set tough targets, especially when confronted by apparently high costs.

Whatever the effects of the current slowdown in the air transport industry (see below), it is reasonable to expect that the comparators will have experienced traffic growth and consequent unit cost reductions by 2005. Thus, even if Aer Rianta were required fully to converge to efficient cost levels by 2005, it would probably still be inefficient compared to the same peer group¹⁴.

In contrast to Aer Rianta's submissions to the Appeal Panel, there is considerable evidence that economies of scale are significant in airport operations, although regulatory approaches to estimating and taking account of this effect may vary. Our Appeal sets out how the MMC analysed economies of scale when setting Manchester Airport's price control (July 1997). Broadly, they concluded that half of operating expenditures were fixed and that the average elasticity of the remaining half with respect to passenger numbers was about 0.6. Similarly, the German Ministry of Economic Affairs, when setting the price cap regulation at Hamburg airport, took into account economies of scale¹⁵. In particular, it established that if passenger growth exceeds 4%, then the X should be raised by half percent for each percentage point of additional passenger growth.

The Commission did not explicitly take account of economies of scale in its benchmarking exercise. In principle, efficiency scores should be "size-adjusted" to ensure that the comparator airports are not simply benefiting from greater economies of scale. This may be appropriate if revised targets are set on the basis of airports operating at a significantly larger scale than Aer Rianta's airports. However, in its original proposals, the Commission used average opex/WLU across a range of airports as the benchmark. For Dublin, for example, the average size of the airports considered is very close to that of Dublin¹⁶. More generally, we understand that IMG selected comparators at least partly on the basis of comparable size (and this selection is clear from the use of separate peer groups for Dublin and the two smaller airports).

Consequently, it would be appropriate to account for significant economies of scale due to further traffic growth, and it is essential to do so if these comparably-sized peer groups continue to be used to set the benchmark. Our illustrative examples in the Summary in paragraph 4 below, show the effect of using the "Manchester" regulatory approach to dealing with economies of scale.

Generally speaking, we submit that the Commission should adjust its pricing formula so that increases in passenger numbers are not reflected in one-for-one increases in cost, rather than simply imposing an additional productivity growth target on the basis of forecasts that are even less reliable at present than usual. This is common regulatory practice. For example, the regulatory formulae applying to British electricity distribution companies allow total revenue to increase at only half the rate at which electricity distributed increases. Total regulated revenue is indexed by (amongst other things) a term called "GR" which has the value:

¹⁴ See also the discussion of technical progress, below.

¹⁵ See for example *Regulation of airports: the case of Hamburg airport* (Hans-Martin Niemeir, 2001).

¹⁶ See Exhibit 2, Page 44, of the Commission's Annex V to CP6.

$$GR_t = 0.5 \left(\frac{\sum P_{ot} \cdot D_{it}}{\sum P_{ot} \cdot D_{it-1}} + \frac{C_{dt}}{C_{dt-1}} \right) GR_{t-1}$$

where P is a price index, D is the volume term (electricity distributed in kWh) and C is the number of customers connected. If D increases by 10% from one year to another, while C is constant¹⁷, the first term inside the brackets will be 1.1, the second will be 1.0, the sum of the two will therefore be 2.1 and so the value of the increase in GR will be half of this: 1.05. Thus, regulated revenue increases by half the increase in volume¹⁸.

Similarly, the Commission could accommodate economies of scale by including a volume indexation term with a value of less than one (as noted above, the MMC approach suggests this value should be 0.3) applied to the proportion of costs accounted for by operating expenditure. This would have the effect of ensuring that easy wins on unit cost reduction resulting from passenger growth are not provided to Aer Rianta, while also insulating the company against tough efficiency targets based on over-optimistic passenger forecasts¹⁹.

(b) Technical Progress

The final component of an effective price control that requires Aer Rianta to reduce operating expenditure to efficient levels is some estimate of technical progress. While it is difficult to estimate expected technical progress reliably, it is undeniable that there will be some easy wins resulting from general improvements in best practice. Conceptually the scope for productivity gains for any individual firm will reflect:

- The gap between its current productivity and the achievable frontier level (best practice);
- The rate at which the business can be expected to close that gap; and
- The rate at which the frontier is expected to shift (technical progress).

Such a frontier shift could result both from economy-wide improvements and specific technical progress in the airport sector. Aer Rianta should not be rewarded through higher profits fully for simply adopting generally-available improvements in productivity. Again, we note that this implies that even convergence towards the efficient benchmarks in 2000 is likely to leave Aer Rianta substantially inefficient compared to best practice in the airports sector in 2005.

The airport industry is unlikely to have the same scope for technological improvement as other sectors in the economy such as telecommunications and electronic media. Therefore,

¹⁷ This is the normal state of affairs for the electricity sector in developed countries: volume growth is almost entirely growth in units/customer rather than new customers since all premises are connected to the grid

¹⁸ See Condition 3A of any Public Electricity Supplier licence for details, such as London Electricity's, available from OFGEM at <http://www.ofgem.gov.uk/elarch/licences/londonpes.pdf>.

¹⁹ Note that, lacking information to carry out such an exercise ourselves, we have summarised the effect of estimates of economies of scale as a simple addition to the annual required opex reduction, using the passenger forecasts reported in the Commission's Determination. If our proposals are implemented and if passenger growth is lower than this, the required unit opex reduction would automatically be less than our illustration.

we believe a relatively unchallenging target for the company already on the efficient frontier could be 1% per year over the next few years.

(4) Summary

Tables 2 and 3 below illustrate the annual opex reduction targets for each of Dublin, Shannon and Cork airports applying the different options set out above. The methodology used in these tables is further explained in Annex 1. For this purpose, we have used data (on benchmarking results and traffic growth) published in the Commission's Determination to calculate these targets. We are not in a position to comment on the accuracy or otherwise of these figures. The tables demonstrate the effects of:

- Different assumptions about economies of scale;
- Different choices of comparators from the Commission's benchmarking sample; and
- Different degrees of convergence towards the efficient benchmarked costs.

For illustrative purposes, we have assumed a modest technical progress of just 1% per annum. This is a matter of judgement for the Commission and, as pointed out in our submissions to the Appeal Panel, this assumption could fall anywhere within the range of 1%-3%.

(i) Dublin

As noted above, it may not be appropriate to restrict Dublin's comparator sample to a single, larger, airport, while still requiring Dublin to make substantial cost savings as a result of economies of scale. However, the Commission's Determination (taking an average across the peer group but making no allowance for economies of scale in the price control) is undoubtedly inconsistent. The Commission must determine whether or not it considers that economies of scale are significant in the airport operations. If it considers that they are, then Dublin needs to be compared to a peer group average, where the average size is similar to that of Dublin (as in the Determination). However, if economies of scale are this significant, it is essential to include some requirement for cost savings resulting from traffic growth.

On the other hand, if the Commission determines that economies of scale are not significant in the airport's operations, then no requirement need be made for cost savings resulting from traffic growth. However, if the Commission makes this assumption, then it has no grounds for averaging across the peer group airports and must use the best peer - Copenhagen - as the sole benchmark.

Aer Lingus believes that economies of scale are significant in airport operations. However, whatever view the Commission takes on this question, the required opex saving for Dublin should be significantly higher than in its original proposals as is illustrated in Table 2 below.

Table 2: Dublin Airport

Peer group	Catch-up	Frontier shift	Economies of scale assumption	Opex target
<i>Top 5 (Europe) (CAR)</i>	50%	0%	<i>Not significant</i>	3.5%
Top 1 (Europe)	50%	1%	Not significant	7.0%
Top 1 (Europe)	100%	1%	Not significant	15.1%
Top 5 (Europe)	50%	1%	Significant	7.1%
Top 5 (Europe)	100%	1%	Significant	10.0%
Top 6 (Worldwide)	50%	1%	Significant	11.0%
Top 6 (Worldwide)	100%	1%	Significant	19.9%

As illustrated above, we conclude that even to achieve the 50% convergence initially proposed by the Commission, Dublin's unit opex should be required to fall by 7% per annum. However, we regard this as insufficiently stretching and propose that the Commission increase the average annual unit opex reduction to a minimum of 10%. The figures above suggest that even this reduction will not achieve full convergence with benchmarked comparators by 2005 (once economies of scale and technical progress are taken into account). Given the high levels of inefficiency, the price control should be set on the assumption that the majority of the improvement takes place within the first three years. Experience elsewhere suggests that such opex reductions should be achievable.

(ii) Shannon

For Shannon, the main differences between our analysis of the Commission's benchmarking figures and those in the Determination relate to:

- Correction of the annual efficiency factor to achieve the Commission's target;
- Faster convergence to efficiency;
- Additional assumption of 1% technical progress; and
- Assumed economies of scale, following the MMC's approach for Manchester Airport.

Table 3: Shannon Airport

Airport	Catch-up	Frontier shift	Economies of scale	Opex target
<i>Top 3 CAR</i>	50%	0%	0%	4% (?)
Top 3	50%	1%	Significant	10.1%
Top 3	100%	1%	Significant	19.0%

As illustrated above, we conclude that even to achieve the 50% convergence initially proposed by the Commission, Shannon's unit opex should be required to fall by 10% per annum. However, given the very high measured inefficiency, Aer Rianta should have a

relatively easy task in cutting inefficient costs at Shannon and we propose a minimum annual efficiency gain of 15%. As stated above in relation to Dublin Airport, the price control should again be set on the assumption that the majority of this improvement takes place within the first three years. We note that even this will not achieve full convergence with efficient comparators by 2005, because of the effects of economies of scale and technical progress.

(iii) Cork

For Cork, the Commission set no efficiency factor in its original determination. We do not disagree with this but we propose that a 1% assumed annual cost reduction for technical progress and an assumption of economies of scale be applied, as above. For the traffic growth forecasts contained in the Commission's Determination, this would imply annual unit opex reductions of 4.5%. Since this reduction, unlike that for Dublin and Shannon, represents general improvements rather than the elimination of inefficiency, it should be spread evenly over the five year period and not accelerated.

C. Opex (Operating Expenditure)

As stated by the Appeal Panel, the Commission should provide an explanation as to how the opening Opex was derived for the purpose of its Determination. Moreover, as stated in paragraph 2(c) above, it is a common phenomenon in regulated industries for costs to increase before a price review and then decrease rapidly following the regulator's decision. The Commission take account of this phenomenon when setting the opening Opex.

D. Depreciation

The Appeal Panel agreed with Aer Lingus' submission that the Commission seemed to have allowed for accelerated depreciation of certain of Aer Rianta's assets in a manner inconsistent with its statutory objective.

We attach a copy of the depreciation policy of BAA as contained in its 2000/01 Annual Report (see Annex 2), which was referred to by the Appeal Panel in its decision. It provides more detailed information on BAA's depreciation policy for fixed assets lives than is provided in the financial accounts of Aer Rianta. We believe that the existing assets net book value should be depreciated in accordance with BAA's life policy. The BAA does not depreciate land. No allowance should therefore be made for depreciation of Aer Rianta's lands as they have considerably appreciated in value since they were acquired. Aer Rianta's depreciation policy for Other Property appears to use an average life of 21 years. Property is normally depreciated over 50 years. This is consistent with the policy of Aer Lingus. This would lead us to believe that Aer Rianta has a policy of accelerated depreciation. We would propose that the Commission should apply the BAA depreciation policy in its revised Determination and, in the case of Other Property, conform to the common practice and apply a depreciation period of 50 years.

E. Transfer and Transit Passengers

We concur with the Appeal Panel's observations that lower or zero charges can be justified in respect of transfer/transit passengers by virtue of the differences in the services which such passengers may avail of. This is consistent with practice at other international airports.

However, we also agree that it is necessary to clarify the extent to which transfer/transit passengers have been taken into account in the Aer Rianta centreline forecasts.

F. Cargo Charges

We agree with the Appeal Panel's finding that the regulatory formula should be applied consistently to cargo and non-cargo revenue for the period of the determination. To avoid the loophole which we have identified, the formulae should provide for a separate cap on cargo and non-cargo revenue or an overall cap throughout the period of the determination.

G. Security Surcharges

We agree that the Commission should clarify the extent to which security charges generally may be passed through by Aer Rianta and the extent to which operating costs associated with the Hold Baggage System are recoverable. In particular, the Commission should clarify the services which it expects to be provided within the maximum by Aer Rianta for the airports users. If any of these services are not provided, a mechanism should be introduced to allow for a reduction in the cap to compensate the users for the non-provision of these services.

H. Passenger numbers/forecasts

We note the Commission's acknowledgement in its correspondence of 20 December 2001 of the error regarding passenger numbers used in the Determination and the maximum average revenues per passenger should therefore be adjusted accordingly.

In relation to the effect of the incidents of 11 September on the forecasted passenger numbers, we would submit that it is too early to factor in any potential long-term reduction in passenger numbers. This issue should therefore be left for consideration at a future review.

I. Interest Payments (under- and over- recovery of maximum airport charges)

In relation to this ground, we would restate the arguments set out in our Appeal and submit that the anomaly regarding the failure to provide for the repayment of interest in the event of over recovery of revenue by Aer Rianta should be rectified by the Commission.

J. Consultation and Users: A Mechanism for Consultation

We recognise that the Appeal Panel has not referred the demand that Aer Rianta be required to consult adequately with users in relation to airport charges and capital expenditure back to the Commission on the basis that this is not expressly provided for in the legislation. However, the Appeal Panel noted that the suggestion by Aer Lingus that the Commission should have a role in future negotiations between users and Aer Rianta was "eminently sensible". The Commission should therefore indicate its willingness to monitor such consultation on an ongoing basis and affirm the principle that it will not make allowance in future determinations in respect of capital expenditure which has been undertaken by Aer Rianta without adequate consultation or where Aer Rianta has acted in a manner contrary to the interests of the users. We believe that it is in the interests of both Aer Rianta and the users to know how capex projects to be undertaken within this determination period will be assessed at the next review in five years.

K. Communication from the Commission

We note the Commission's acknowledgement that a number of computational errors were made in its initial Determination. In order to ensure that no such errors are contained in the revised Determination, we would request that the Commission provide all of the Appellants with a draft of the revised yield calculations together with an explanation of any changes made to the figures contained in the original calculation as set out in Appendix 1 to CP8/2000. The Appellants should be afforded an opportunity to review and seek clarification on these changes prior to the revised Determination being issued.

Annex 1: Derivation of illustrative proposals for opex reduction targets

Assumed benchmarking peer group and convergence rate	Source	(a) Required reduction over five years	(b) Annual required reduction $1-(1-a)^{(1/5)}$	(c) Frontier shift <i>Assumed</i>	(d) Traffic growth to 2005 <i>CAR figures</i>	(e) Annual traffic growth $(1+d)^{(1/5)} - 1$	(f) Response of opex to traffic growth <i>Using MMC assumption</i>	(g) Allowed increase in total opex $f \times e$	(h) Reduction in unit opex $\frac{f}{(1+g)/(1+e)}$	(i) Required annual opex reduction $b + c + h$
Dublin										
Top 1 Europe	50%	26.6%	6.0%	1.0%	29.8%	5.4%	1.0	5.4%	0.0%	7.0%
Top 1 Europe	100%	53.2%	14.1%	1.0%	29.8%	5.4%	1.0	5.4%	0.0%	15.1%
Top 5 Europe	50%	12.2%	2.6%	1.0%	29.8%	5.4%	0.3	1.6%	3.6%	7.1%
Top 5 Europe	100%	24.5%	5.5%	1.0%	29.8%	5.4%	0.3	1.6%	3.6%	10.0%
Top 6 Worldwide	50%	28.2%	6.4%	1.0%	29.8%	5.4%	0.3	1.6%	3.6%	11.0%
Top 6 Worldwide	100%	56.4%	15.3%	1.0%	29.8%	5.4%	0.3	1.6%	3.6%	19.9%
Shannon										
Top 3 (inc. Cork)	50%	28.2%	6.4%	1.0%	21.1%	3.9%	0.3	1.2%	2.6%	10.1%
Top 3 (inc. Cork)	100%	56.5%	15.3%	1.0%	21.1%	3.9%	0.3	1.2%	2.6%	19.0%
Cork										
No benchmarking	N/A	0.0%	0.0%	1.0%	30.1%	5.4%	0.3	1.6%	3.6%	4.6%