Mr William Prasifka

Commissioner for Aviation Regulation

36 Upper Mount Street

Dublin 2

I enclose the response of Aer Lingus to the Commission on the Proposed Maximum Levels of Airport Charges.

Please do not hesitate to contact me further in relation to the submission enclosed.

John O'Donovan

Company Secretary

Aer Lingus Response to the CAR on the Proposed Maximum Levels of Airport Charges

Summary

We believe that the Commission's draft determination fails to achieve the statutory requirement set out in Section 33 of the Aviation Regulation Act:

> *In making a determination the Commission shall aim to facilitate the development and operation of cost effective airports which meet the requirements of users…*

Aer Lingus is the largest user of all three airports regulated by the Commission and the only airport user operating a full range of services from these airports. From what we have seen, we do not believe that the draft determination will facilitate the development and operation of cost effective airports. It certainly does not meet our requirements.

We believe that the consultation process has failed in its statutory obligation to allow interested parties to make meaningful representations.

The Commission has not provided enough information in its consultation paper for us to comment (to the degree of detail that we would like) on the main issues on which the Commission claims to be seeking users' views. Through its lack of detailed information and inadequate consultation, the Commission has failed to engage the principal airport users in the process and therefore cannot be aware of what their detailed requirements actually are. The public meetings could have been used to explain the proposals in more detail. Instead the Commission sought views before the proposals had been properly explained. We did not see any benefit to Aer Lingus in commenting in the absence of detailed and transparent proposals, if to do so would produce no additional information before this written response was due.

We recognise that we have had opportunities to make any comments to the Commission that we like. However, this is not the point. We need specific proposals, with the costs and benefits set out in detail if we are to comment. There are too many gaps in the Commission's published papers for this to be possible. For example, in its response to a joint letter from Aer Lingus and Ryanair requesting further information, the Commission suggested that we provide our views on what X in the CPI-X price control formula should be. This is totally unreasonable. X is the outcome of a complex analysis of costs – taking account of operating and capital expenditure projections, capital depreciation policy, traffic forecasts and assumptions on non-regulated revenue.

While we would wish to provide a view on this issue, most of these key inputs to the calculation are absent or vague in the consultation paper and without them we cannot possibly comment on what the *output* of that calculation should be.

Like any business, we do not have absolute requirements: we weigh up the costs and benefits of any service that is offered to us. We cannot accept a vague proposal for the costs of unspecified services from the monopoly airport provider over the next five years. We therefore reject the majority of the Commission's proposals, simply because we do not have enough information to form a considered view.

The Commission's proposals on investment have not been related back to any specific projects. We therefore reject these projections. A simple halt to the continuing gold-plating investment programme that Aer Rianta has been carrying out would best meet our requirements at this stage. We note that the Commission has an opportunity to review its determination in two years time. We recommend that this period be used for a proper consultation exercise in which users' views are sought and heeded on the specific investments required at each of the airports. Allowed capital expenditure for this period should therefore be zero, except for necessary safety measures at Cork and some minor items on which to date there has been consultation.

We have no information on the derivation of the regulatory asset base and therefore cannot accept the figure provided by the Commission. However, the costs of the existing asset base are clearly excessive. Asset costs affect charges through depreciation and a return on capital. The Commission has provided no information whatsoever on depreciation. Its estimate of the cost of capital and Aer Rianta's allowed return is ridiculously high. Other Irish regulators have set the rate of return at similar levels to those for identical businesses in the UK, so Aer Rianta's allowed return should be no higher than the rate for airports in the UK. The Commission's proposed cost of capital is well in excess of the rate determined for airports in the UK in 1997 and about 2.5-3 percentage points higher than the likely rate today – resulting in additional revenue of over IR£10 million annually to Aer Rianta.

The Commission has required expenditure reductions to reflect inefficient operations at Dublin and Shannon. However, Aer Rianta has a full five years to close only half of the gap between its excessive cost levels and what the Commission has identified as efficient cost. Furthermore, the Commission makes no reference to the effects of traffic growth (indeed it has refused to make its assumptions on this key statistic available) or technical progress. Aer Rianta can reduce operating expenditure per passenger without effort as traffic increases and as a result of economy-wide technical progress.

It could, therefore, meet the Commission's targets essentially without effort. Alternatively, it could beat the target and make excess profits. Either way, it will not necessarily close any of the gap with more efficient international comparators, which will be taking advantage of traffic growth and technical progress to pull further ahead.

Finally, we regret that the Commission has not made any use of its powers to act as the customers' defence against the monopoly power of Aer Rianta. We do not have a free choice of airports. Faced with high charges or poor service at Dublin, we cannot simply go elsewhere as can a firm choosing between competing suppliers. The regulator is there to act as a substitute for effective competition. However, the Commission has failed to require Aer Rianta to contract with its customers over service standards, to consult over investment programmes or to submit its charging structure for approval. These are essential elements of the regulator's role in acting in the interests of airport users and we require the Commission to fulfil its statutory obligation.

In the remainder of this document we present more details of our views on each of the topics in the consultation paper.

1: Investment

The Commission has not provided enough information to allow us to assess and approve its capital expenditure assumptions. We are not in a position to comment on what Aer Rianta's allowable capital expenditure should be, since we are not familiar with the unit costs of airport construction projects. Given a list of the *physical* projects underlying the capital assumptions, we could comment in detail and set out our requirements as the largest user of the three airports. However, the Commission has not provided such information[1] and we cannot approve of lump sums for unspecified purposes.

Accordingly, we do not support any of the capital expenditure projections or the recoverable CAPEX programme set out by the Commission.

If capital expenditure is to be determined according to the requirements of airport users it is essential that properly specified and costed investment plans – with justification and alternatives – be set out before users. This

[1] Or related information. For example, will any of the capital expenditure set out by the Commission create additional revenue – such as fares for use of the internal railway or Government grants? Similarly, should some of the investment projects create offsetting operating expenditure savings? Any IT investment, for example, should be self-funding. Without knowing the net cost to ourselves and other airport users we are in no position to give a view on the cost/benefit trade-off in such projections and therefore cannot approve them.

has not been done so far during this consultation process and there is insufficient time for it to happen now.

A simple halt to further gold-plating by Aer Rianta would best meet our requirements at this stage. We therefore require that the Commission sets allowed capital expenditure at zero for all investment categories except the necessary alterations to the terminal building at Cork and some other minor items.

We note that the Commission can review its determination in two years time and we require that it does so, using the period up to then to consult (and require Aer Rianta to consult) with airport users on their investment requirements. Until such consultation has taken place, we do not see how any investment can be regarded as meeting user requirements, since the main users have not been consulted in any meaningful sense.

As requested by the Commission, we now present our views on the limited capital expenditure information provided in the consultation paper, for each of the three airports.

Dublin

Access/Egress/Roads. We do not require this development and therefore require that it be rejected.

Terminal building. We do not require this development and therefore require that it be rejected. We do not have any information on what benefits for users this investment will produce and therefore reject the projected expenditure.

North Terminal. We do not require this development and therefore require that it be rejected.

New Piers. We would support a cost effective and efficient programme for Pier D. Bearing in mind the gold-plating and inefficiency identified and disallowed by the Commission in relation to Pier C, we need further information before we can give any support to specific capital expenditure projections for this item. We reject any expenditure relating to other projects, since we have received no information about them and we do not require them.

Cargo. We do not require this development and therefore require that it be rejected.

Stands and airfield. We do not require and object to being expected to fund a new runway at Dublin within the period covered by the Commission's projections. We cannot support any expenditure on any other items without being provided with information on what is proposed. Accordingly, we reject all capital expenditure in this category until proper consultation has been carried out. We therefore require that the

Commission allow no investment in this category until after a review in two years time.

Rail. We do not require this development and therefore require that it be rejected.

We are not prepared to pay for any internal rail system or connection to the national rail system through airport charges. If passengers are prepared to pay for the system through fares, any expenditure should be met through that mechanism. If social objectives, such as reducing road congestion, are considered important, such expenditure should be met through central Government grants. Either way, any such system should be outside the regulatory till. We reject the idea of paying additional airport charges for a system that we do not require.

Shannon

We do not require this development and therefore require that it be rejected.

We do not have any information on what benefits for users any of the investments allowed for Shannon will produce and therefore reject the projected expenditure.

We are surprised that the Commission is proposing to allow over £21 million of additional capital expenditure for a terminal that the Commission itself has recognised to be gold-plated, having disallowed £7 million past expenditure as inefficient and unnecessary.

Cork

Access/Egress/Roads. We do not require this development and therefore require that it be rejected.

Terminal building. Aer Rianta is engaged in a consultation process over its plans for the new terminal and we are participating. Some capital expenditure should therefore be allowed for a new terminal at Cork over the next two years. However, the Commission should be prepared to assess the efficiency of any such investment if, as we require, it carries out a more detailed review in order to revise its determination in two years time. If elements of the project are excessively specified, or inefficient, they should not be passed through into airport charges (just as the Commission disallowed inefficient asset costs at Shannon).

Stands and airfield. We do not have any information on what benefits for users this investment will produce and therefore reject any projected.

2: Cost of capital and rate of return

Asset base

We have not been able to reproduce the Commission's calculation of the starting value of the RAB from the limited information contained within the consultation paper. In the absence of more detailed information, therefore, we cannot support the Commission's proposed value.

As well as failing to provide details of the calculation of the RAB, the Commission has also failed to provide any analysis of items contained within it. Some of Aer Rianta's assets may have been constructed with grants provided by the EU and other bodies. It would clearly be inappropriate for such investment costs to be recovered twice, once through the grant and once through passenger charges.

We support the Commission's decision to use an indexed historical cost approach to estimating and rolling forward the regulatory asset base.

Cost of capital

We reject both the Commission's conclusion that Aer Rianta's cost of capital is between 8% and 9% and the decision to allow the company a return above this range. We take it that this figure refers to the pre-tax real cost of capital, although it is not clear from the Commission's Paper. This is the standard figure quoted in other regulatory decisions.

The Commission Paper refers to "decisions concerning the cost of capital by other Irish economic regulators and also decisions of a similar nature elsewhere." It goes on explicitly to mention other regulated airport operators. We do not understand how the Commission reached a figure of 8-9% on the basis of these comparisons, since the relevant decisions we have identified are below this range.

Decisions by other Irish economic regulators

In February 2000, the Commission for Electricity Regulation (CER) published its approval of use of system charges for access to ESB's regulated network[2]:

- the pre-tax real cost of capital for the transmission business was set at 6½%;

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[2] *Commission for Electricity Regulation – Approval, USE OF DISTRIBUTION AND TRANSMISSION SYSTEM CHARGES*, February 2000 available at http://www.cer.ie/cer0008.pdf.

- the cost of capital for the distribution business was set at 6½%.

The CER also engaged in substantial consultation regarding the cost of capital for a hypothetical new generation entrant[3] and concluded that its cost of capital should be set at 6%.

The telecoms regulator, the OTDA, has set Eircom's cost of capital at 12%. However, this very high figure reflects the rapid rate of technical progress (and therefore technological obsolescence) in the telecoms industry. For example, NERA's report on British Telecom's efficiency[4] estimated the company's cost of capital at 12.5%.

Both of these industries differ from airport operation in technical and other characteristics. However, the decisions by these two Irish regulators do appear to indicate that the cost of capital for a regulated business in Ireland is essentially identical to the cost of capital for a similar business in the UK. This naturally suggests that the Commission should consider BAA as a starting point when determining Aer Rianta's cost of capital.

Other regulated airport operators

At the last quinquennial price control review in the UK:

- BAA's cost of capital was set at 7½%;
- Manchester Airport's cost of capital was set at 7¾%.

Both are substantially below the Commission's estimates of Aer Rianta's cost of capital. However, if anything we would expect Aer Rianta's cost of capital to be below these levels, for three reasons:

- ❒ Aer Rianta's state ownership should result in a lower cost of debt and a wider distribution of equity risk and Ireland's membership of the Eurozone should result in a lower risk-free rate than in the UK[5]; and
- ❒ UK regulators have generally reduced their estimates of the cost of capital substantially since the mid-1990s. For example:

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[3] *Best New Entrant Price 2001, The Commission's Decision*, December 2000. www.cer.ie/cer0090.doc

[4] Oftel, July 2000.

[5] As we noted in our initial submission, Eurozone short-term bond yields are 50 basis points below those of UK Government.

- the Competition Commission estimated the cost of capital for water companies at 6.3%[6] in 2000, down from about 7% five years before;

- OFGEM estimated the cost of capital for electricity distribution at 6½% in 1999, down from 7% five years before;

- OFGEM estimated National Grid's cost of capital at 6¼% in 2000, down from 7% four years before;

- OFGEM has just published its draft proposals for BG Transco, setting the cost of capital at 6.1%, down from 7% proposed by OFGEM and accepted by the MMC in 1997.

These changes reflect reduced estimates of the risk-free rate and the equity risk premium, both of which are common across sectors. It therefore seems very likely that the current MMC/CAA reviews of BAA and Manchester Airport will result in a cost of capital significantly lower than 7½%.

❒ The CAA's recent position paper[7] on the cost of capital confirms this shift. Reductions in the assumed risk free rate and equity risk premium reduce the range for the post tax cost of equity by 100-110 basis points (one percentage point) and the assumed cost of debt has fallen by 55-75 basis points. Overall these changes have reduced the cost of capital by more than a percentage point. Changes in UK taxation may prevent this full reduction feeding through to the final pre-tax figure but this is irrelevant to our purpose in assessing the cost of capital for Aer Rianta. It seems likely that the CAA will set an assumed cost of capital in the range 6-6½% before making any adjustments for this UK-specific tax change.

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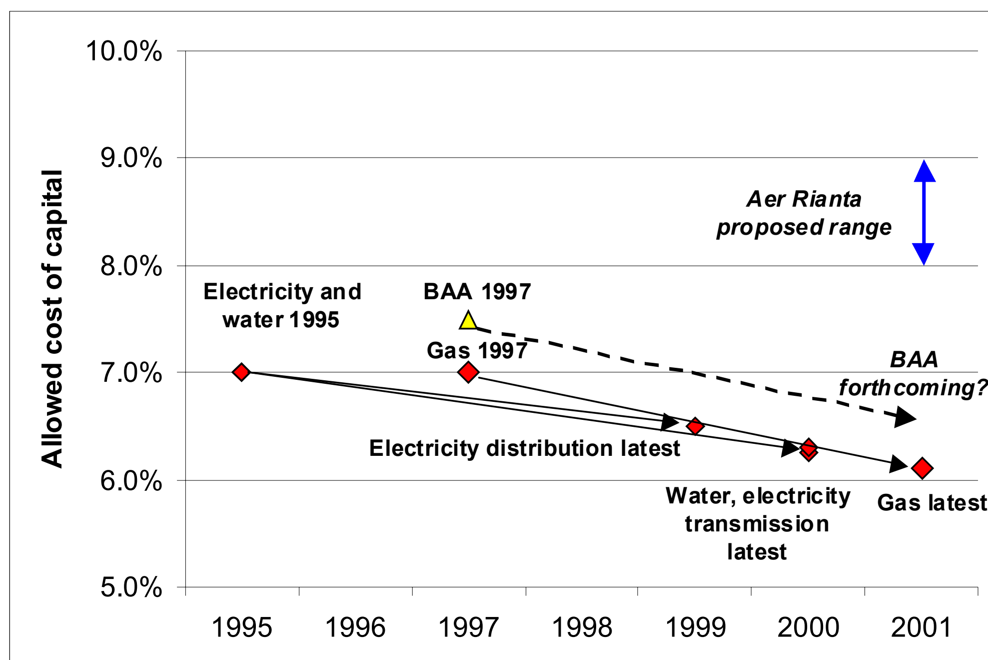
[6] The water regulator typically sets rates of return on a post-tax basis. This is a pre-tax figure we have derived, to make the numbers consistent with others reported here.

[7] *Cost of Capital. Position Paper.* Civil Aviation Authority June 2001 (available at http://www.caaerg.co.uk/downloads/costofcapital.pdf)

We illustrate this history, in comparison to the Commission's proposed range, below:

The proposed range for the cost of capital is out of line with UK regulatory practice



We note that:

- the CER and OTDA's decisions suggest that there should be no "country premium" over UK rates for Ireland[8];
- BAA in the UK, in a similar business to Aer Rianta, was allowed a cost of capital of 7½% at the last price control review; and
- because of reduced interest rates and reduced equity risk, this cost should fall by 1-1½% during the current airport charge review in the UK (tax changes in the UK may act against this but these changes have no relevance for Ireland).

[8] Given Ireland's membership of the Euro, there should if anything be a discount.

Given this evidence, it is hard to understand the Commission's view that a survey of comparable decisions results in an estimate of the cost of capital above 8%. If anything, Aer Rianta's effective state guarantee for necessary investment required to meet international obligations should result in a cost of capital significantly below that of BAA. We recommended a cost of capital in the range 3-4% in our response to Consultation Paper CP2, reflecting a small premium on the cost of Government debt. We stand by that assessment and we reject the excessive range proposed by the Commission.

Rate of return

The Commission's view that the allowed rate of return should be "slightly greater, over the medium term, than the company's cost of capital" is not consistent with standard regulatory practice or economic theory. The result of this decision would be:

- to give Aer Rianta an incentive to continue to invest excessively (it can raise capital for investment at a lower rate than the return it would achieve on that investment);
- to reduce the incentive for unit cost efficiencies in the investment programme (an area in which Aer Rianta's performance has been poor in the past); and
- to force customers to pay charges that are higher than the costs of providing facilities and services.

Returns should exceed the cost of capital only when performance exceeds the expected level

Aer Rianta has monopoly power and the Commission regulates to simulate the effects of competition. As the Commission points out in its paper, competitive markets always tend to erode returns above the cost of capital. To reproduce the incentives faced by a competitive firm, the expected rate of return for a regulated company should therefore be set equal to the cost of capital. Obviously, both regulated and competitive firms can make returns above the cost of capital by reducing costs. In both cases, these additional returns are temporary and will be removed by new entry, in the case of competitive markets, and a periodic price review in the case of regulated monopoly.

We would have no objection to Aer Rianta making returns above the cost of capital arising from continuous excellent performance in service delivery *and* reducing costs. This is why we support incentive regulation (such as CPI-X). If Aer Rianta beats the expected cost profile set by the regulator, it will and should[9] make returns above the cost of capital, until the next price control review. However, we do not see any justification for allowing an *expected* rate of return above the cost of capital.

Capital expenditure is a cost, not a measure of service quality

We suspect that the decision reflects the Commission's concern to ensure that Aer Rianta completes its capital expenditure programme. This concern is quite common among regulators, but allowing expected returns above the cost of capital is not the way to do it. What matters is service quality, not investment and regulators often see capital expenditure as a leading indicator of service quality. However, simply adjusting a single variable to achieve two objectives (preserving service quality and minimising cost) will not work. It is well known that CPI-X can provide an incentive to under-invest. Creating a broad incentive to over-invest as a counter-weight to this is most unlikely to result in exactly the "right" incentive power. Instead, regulators should incentivise quality (or monitor *physical* investment measures) and provide incentives to minimise all costs.

We return to this issue of service quality in our response to item 7.

3: The efficient and effective use of resources

We support the Commission's decision to require operational efficiency improvements at those airports identified as inefficient compared to the best practice identified in its benchmarking exercise[10]. Customers should not be required to pay for inefficiency.

We are concerned, however, that the Commission is not making effective use of its benchmarking results, nor recognising that unit cost improvements will take place because of factors that are partly outside Aer Rianta's control (and for which the airport operator should not, therefore receive credit in the form of returns above the cost of capital).

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[9] assuming such a profile reflects reasonably challenging efficiency targets

[10] We require, however, that the Commission re-examine the details of the analysis carried out be its consultants. There are errors in the data tables presented in the paper. There are also missing items of data: it is not obvious why the consultants were unable, for example, to discover whether Glasgow has a rail link or to count the number of gates. We are also concerned that the US airports in the survey, which could provide useful benchmarks, were excluded from the comparators actually used to determine Aer Rianta's performance.

If our understanding of the Commission's proposals is correct:

- customers will continue to pay for inefficiency throughout this price control period;
- even by the end of the period, charges at Dublin and Shannon will fully compensate Aer Rianta for half of its existing operating inefficiency;
- the efficiency targets do not appear to take account of the effects of traffic growth, which will almost certainly allow Aer Rianta to beat these cost reduction targets without effort; and
- the efficiency targets do not appear to take account of any expected technical progress and general economy-wide improvements in productivity growth. Aer Rianta can and should be expected to take advantage of such improvements and it should not be rewarded for "normal" cost efficiencies of this sort.

We now discuss each of these points in more detail.

Allowing Aer Rianta a glide path

Our interpretation of the Commission's proposals is that its efficiency targets relate to the last year of the price control. Thus, a 25% target represents annual cost reductions of roughly 5%.

We do not accept that it is necessary for the Commission to allow a "glide path" of this sort. Customers should not have to pay for costs inefficiently incurred. Inefficient firms in competitive markets make returns below their cost of capital. Those that are recognised as taking steps to redress this inefficiency do not have difficulty raising funds for investment because investors recognise that the market will reward efficient investment. A regulator can behave in the same way as the market without damaging the credibility of his commitment to allowing the firm to finance efficient operations in the future. Regulated revenue should not follow the time path of cost reductions, just as inefficient firms in competitive markets are unable to charge a price premium to reflect their costs converging to prevailing best practice.

Reducing inefficiency by only 50%

We do not understand why the Commission is allowing Aer Rianta to be compensated for 50% of its inefficient operating expenditure even at the end of the period. If Aer Rianta is incurring inefficient operating costs, these should be eliminated. If the Commission's decision reflects its

uncertainty about the validity of its benchmarking it should say so. However, we note that Aer Rianta has already been given the benefit of the doubt in the analysis by being compared to average performance of a peer group, rather than best practice performance.

In the UK, OFGEM's initial electricity distribution price controls in 1999 required inefficient companies to achieve efficient operating expenditure levels in five years. Final proposals required a 75% reduction in the gap between actual and best practice performance but reduced the period for this reduction to three years.

We accept that it takes time to reduce operating expenditure (although as noted above, we do not believe that prices need to follow the same profile). However, even the most thorough cost reduction programmes can be implemented in significantly less than five years. A firm in a competitive market would have nothing like as long to rescue itself from the inefficiency highlighted by the Commission in it's benchmarking exercise.

Volume growth

We are not entirely clear what the Commission is proposing to assume about the relationship between costs and volumes. One interpretation of the proposals is that unit operating cost (per WLU) is assumed to remain constant, in the absence of efficiency targets. If this is the proposal, it provides Aer Rianta with an extremely soft cost target since costs do not increase one-for-one with volumes.

Some costs are fixed, at least in the short or medium term. For example, most of Aer Rianta's head office costs should not rise as a result of increased traffic. Other costs do increase with traffic, but rarely by the same proportion.

The UK Competition Commission (formerly MMC) analysed this issue in detail when setting Manchester Airport's price control (July 1997). Broadly, they concluded that about half of operating expenditures were fixed and that the average elasticity[11] of the remaining half with respect to passenger numbers was about 0.6.

If traffic were to increase by 25%, on these figures:

- half of all operating expenditure would remain constant; and
- the remaining half would increase by 0.6*25% = 15%.

[11] The MMC report estimated elasticities separately for detailed cost categories. The 0.6 figure is our weighted average.

Overall, operating cost would therefore rise by about 7½%. If revenue were to increase by an amount equivalent to 25% of operating costs, the airport would make excess returns equal to about 17½% of total operating costs – essentially without effort. Equivalently, unit operating costs would fall by about 17½%, again essentially without effort.

We are therefore concerned that the Commission's operating efficiency targets are essentially toothless. Aer Rianta could be expected to achieve most or all of the required saving without changing its working practices but simply by benefiting from economies of scale as traffic grows.

We hope that our interpretation of the Commission's proposals in this regard is incorrect. If it is correct, the price control proposals are deeply flawed. We require the Commission to explain, in detail, it's position.

Technological progress

Incentive regulation should aim to allow regulated firms:

- reasonable returns equal to the cost of capital for meeting a reasonable expectation of performance; and
- higher returns for exceptional performance.

We believe (although the paper is unclear on this point) that the Commission is assuming that any cost reduction beyond its efficiency targets should be rewarded. This is contrary to good regulatory practice and against customers' interests. Regulators elsewhere typically set some reasonable target for cost improvements to reflect general technical progress (world-wide in the sector, or across the economy). The company is expected to meet these targets and will make higher returns only if it exceeds them.

If we understand the proposals correctly, the Commission assumes either that:

- there will be no technical progress in the airports sector or the economy generally over the next five years; or
- Aer Rianta should receive excess returns for performing as well as any other firm in the economy in adopting innovations.

We do not agree with either proposition. If no allowance is made for general productivity growth then:

- again, Aer Rianta will meet its cost reduction targets with ease; and

- at the next price control review, Dublin and Shannon will not have closed half of the efficiency gap with their comparators as the regulator hopes – because those comparators will themselves all have improved.

Regulators elsewhere typically make very broad-brush assumptions when considering this issue – an additional 1-2% on the X-factor, for example. Again, the Competition Commission in the UK considered this in more detail at the last quinquennial review of regulated airports and concluded that labour productivity could be expected to improve by 2-4% per year. Indeed BAA itself stated that it could achieve labour cost reductions of 2% in real terms, representing 4% labour productivity growth and a 2% per annum increase in real wage costs.

We do not expect the Commission to undertake a detailed study of expected productivity growth. There are so many uncertainties involved that calculating a very precise number is unlikely to be meaningful. However, we are certain that the number is not zero as (one interpretation of) the Commission's proposals would imply.

Alternative proposal

To illustrate the way in which these factors influence the analysis, we have constructed an alternative efficiency target to that proposed by the Commission. We assume:

- traffic growth at each of the three airports of 5% p.a.[12];

- half of operating expenditure is fixed with respect to passenger numbers (or WLUs) and half responds with an elasticity of 0.6, as in the MMC analysis described above;

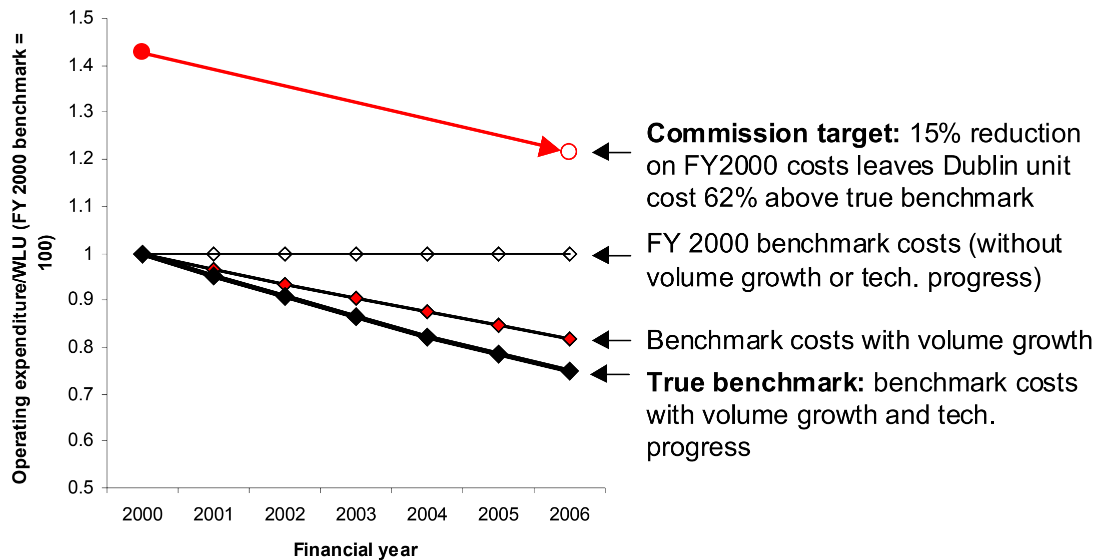
- 1½% improvement in "best practice" operating costs per year, to reflect technical progress; and

- a requirement to converge fully by 2006 to the best practice identified by the Commission in its benchmarking analysis of financial year 2000 (FY 2000).

[12] We use this number for illustrative purposes, since the Commission has not set out its own growth assumptions.

We illustrate the results for Dublin below:

Meeting the Commission's efficiency targets would lead to an increasing gap between Aer Rianta's performance and best practice in the Commission's survey



As can be seen from the chart above, Dublin airport begins in FY 2000 with unit operating expenditure 42% above that of the benchmark comparator (i.e. it is 30% inefficient, as in the Commission's assumptions). Requiring it only to close half of this gap *to the FY 2000 benchmark* by 2006 actually widens the gap, rather than reducing it. Technical progress and volume growth drive benchmark costs down by over 25% over the period.

Therefore, Aer Rianta's airports should be required to make the following percentage reductions in operating expenditure by 2006, to converge fully to the efficient benchmark:

- 48% at Dublin (assuming 30% existing inefficiency);
- 63% at Shannon (assuming 50% existing inefficiency); and
- 25% at Cork (assuming 0% existing inefficiency).

Obviously, alternative assumptions could be made about traffic growth and technological progress. However, these factors must be taken into account and any reasonable assumptions regarding them should lead to efficiency targets similar to those above.

Benchmarking - conclusions

Aer Rianta's efficiency targets are too soft, because unit operating expenditure can be expected to fall as traffic volume increases and as a result of general technological progress. It is likely that Aer Rianta would exceed the target cost reductions essentially without effort and make excess returns. This would be quite inappropriate and inefficient. Firms in competitive markets do not realise above-average profits as a result of general market growth and general technological progress.

Alternatively, Aer Rianta could take the soft option and simply match the Commission's targets. As we illustrated above, if it does this it will end the period relatively more inefficient than it began, as comparator airports make unit cost reductions to reflect volume growth and technical progress.

We require instead that the Commission adopt tougher targets to reflect these factors and requires full, and rapid, convergence to those targets. Any existing costs in excess of the efficient costs of providing services should not be recovered from airport users. Under the Commission's existing proposals, this burden of inefficiency will remain and increase.

4: The contribution of the airport to the region in which it is located

We support the Commission's views that all three airports should be considered under this heading. Regional development is promoted by providing efficient and cost-effective airport services, not by encouraging unnecessary investment projects in the hope of "contributing" to the region's development.

In the absence of any other constraints, airport charges at each of the three should fully reflect the costs of providing services. At present, the bilateral agreements distort free choice between airports. To reflect this, an 80% discount is applied to landing charges on flights where the immediate proceeding point of take off was within the State and where the flight forms part of a transatlantic flight. The Commission should impose a sub-cap on this charge to ensure that this policy continues as long as the provisions of the bilateral agreements remain in force. We agree with the Commission that any subsidies to Shannon or Cork should be funded by the State (either directly, or by accepting a lower return on its investment in Aer Rianta), not through airport charges at Dublin.

5: The level of income of the airport authority

Single till

We welcome the Commission's decision to retain the single till approach, because this system ensures that the benefits of commercial operations at airports are distributed among all the organisations contributing to the airport's operations. The decision to exclude Aer Rianta International and Great Southern Hotels from the single till is consistent with the recommendation we made in our response to CP2. We were concerned that otherwise there would be a danger that speculative ventures would be funded out of monopoly revenues. An alternative approach would be to require Aer Rianta to sell these businesses, use the proceeds to fund any necessary investment in its core business and to concentrate solely upon that core business in future. This would achieve the aim of preventing speculative future investments being funded through monopoly charges while ensuring that the benefits of past such investments also accrue to those who (in effect) guaranteed them: the users of Aer Rianta's domestic airports.

We are not clear, however, about the meaning of the Commission's suggestion that future commercial developments could be excluded from the regulatory till. In the absence of any further information, we must reject this idea.

Our reasons for opposing such an approach are both principled and practical. Increasing the powerful incentives on Aer Rianta to invest in commercial activities when those activities are located at the airport may not be in the interests of passengers. If terminal and other capacity does indeed become constrained, we are concerned that Aer Rianta could neglect the aeronautical activities and devote a high proportion of its own efforts and space in terminal buildings to new commercial developments. The appropriate response to expected congestion is to give Aer Rianta incentives to meet service quality standards, not incentives to build shops and bars.

In any case, as we have argued in our earlier submissions, commercial revenues should benefit all those involved in bringing additional passengers to the airport. If commercial revenues rise, it will principally because traffic increases as a result of airlines choosing to use Irish airports as a destination or transit point.

Our practical concerns relate to the difficulties of distinguishing between new commercial revenue (outside the till) and old commercial activities (within it). Regulators inevitably face great difficulty in properly ring-fencing regulated revenue because the incentives on regulated firms to categorise revenues as being outside the till are so great. If the cut-off

point is determined by specific investment projects, then Aer Rianta has a perverse incentive to build new commercial developments rather than to maintain and improve existing ones.

6: Operating and other costs

We provided our views on this topic under topic 3, above. We welcome the use of benchmarking but we believe that the cost targets are insufficiently stretching for Aer Rianta.

7: The level and quality of services

Service quality

We regret that the Commission has not taken a lead in establishing and developing meaningful and enforceable service quality standards. As we discuss above, we believe that the Commission should fulfil its objective of incentivising Aer Rianta to reduce costs more effectively by measuring service quality directly and penalising failure to perform. Instead, the Commission's main concern in this area appears to be with aggregate capital expenditure, which bears only a loose relationship to quality. A facility can be expensive without necessarily providing high service quality. Simply monitoring compliance with investment targets will not allow the Commission to tell the difference between cash spent to improve quality and cash spent wastefully.

We require the Commission to ensure that Aer Rianta signs service level agreements with airlines and other interested parties. Because of Aer Rianta's monopoly power, it has little incentive to sign such agreements (or to include meaningful targets and enforceable penalties) without regulatory pressure. The airlines are well placed to observe service quality and we therefore do not need the Commission to take on an onerous burden of monitoring but we need support to be given that role. Without such incentives, Aer Rianta will simply spend up to its investment allowance, without regard for whether any new facilities will be used or useful.

Structure of charges: sub-caps

We would need to see a fully specified set of proposed tariffs before taking a final position on any change to the existing tariff structure. We discuss this issue further under item 9, below.

We are opposed to a fixed sub-cap on off-peak charges. While Dublin airport remains co-ordinated but not fully co-ordinated, we would support

compensating discounts for any airline who comply with a request from the co-ordinator (not Aer Rianta) to change their proposed schedule.

As noted above, we believe that charges should reflect service quality. Users should not pay for services they do not receive. If the Commission is unwilling to promote service-level agreements, it should at least require compensation payments for the use of low-quality facilities. We therefore require that the Commission imposes a sub-cap to reinstate the discount for users of Pier A (which was withdrawn without consultation last year).

We also see merit in a sub-cap for use of the secondary runway. The use of this runway at peak times would increase efficiency by allowing certain aircraft types to operate while the main runway is in use. We believe that total runway capacity could increase by 25% or more as a result of such a change. Aer Rianta as a monopolist acting inside a single revenue cap has no incentive to offer discounts to encourage such efficient use of the secondary runway and we therefore recommend that the Commission establish a sub-cap for this purpose.

8: International practice

We provided our views on this topic under topic 3, above. We welcome the use of benchmarking but we believe that the cost targets are insufficiently stretching for Aer Rianta.

9: Imposing the minimum restrictions on the airport authority

We require that the Commission should interest itself in the structure, as well as the overall level, of charges. In the past, Aer Rianta has introduced discriminatory charging structures that have taken years to unravel. Furthermore, tariff revisions are typically introduced without adequate consultation. Occasionally Aer Rianta has given notice of its intentions in general terms but users are not consulted on actual proposed tariff levels until it is too late to change them.

As we noted in our earlier submissions, Aer Rianta is a monopoly provider. It is not in competition with other airports in any meaningful sense. Aer Lingus is certainly in no position to transfer its operations out of Ireland. We have no commercial redress against any charges Aer Rianta chooses to set. By the time appropriate action has been taken through the courts, much of the damage may already have been done. It is an essential function of an aviation regulator to require consultation on, and subsequently approve or withhold consent for, changes in relative tariffs.

10: National and international obligations

We have no comments on this section of the paper.

Detailed questions for the Commission

Aer Lingus and Ryanair jointly submitted a list of questions in a letter of 17th July requesting additional information essential to an understanding of the price control. The great majority of these questions received no substantive response in the Commission's reply of 19th July. We therefore repeat these questions in summary below, with comments on the Commission's replies.

1. The recoverable capex programme. We need to know what specific investments are included in the Commission's proposed allowed capital expenditure for each airport. What specific benefits will customers receive, in terms of new or improved facilities, for the costs they are expected to fund? We do not regard the breakdown in the consultation paper as adequate.

2. The regulatory asset base. We need to understand how the Commission has arrived at its figure for the starting value of the RAB since we have been unable to reproduce this calculation using the information in the consultation paper.

3. Cost of capital. The Commission informed us that decisions by OTDA and CER informed its decision on the cost of capital. We do not understand how these decisions can result in any decision other than to set Aer Rianta's allowed return no higher than the cost of capital of UK airports, since neither regulator took the view that the cost of capital in Ireland is higher than in the UK.

4. Benchmarking. The Commission should explain its decision to exclude some surveyed airports from its analysis and its decision to allow Aer Rianta to remain inefficient.

5. Commercial revenues. We requested the Commission's assumptions on commercial revenues. This is an essential element of the price control calculation. Without it, it is quite impossible to determine levels of charges or X even with full information about costs. In its reply, the Commission suggested that this was a minor detail. It is not. Without knowing what assumption is used, we cannot begin to understand the figures quoted for charges since we do not know the assumed gap between total costs and airport charges.

6. Details of the charges. The Commission consulted earlier in the process on which services should be covered by regulated charges. It has not published any conclusions on that issue. Again, we need to know what it is we are being asked to pay for.

7. Traffic forecasts used by the Commission. As a simple matter of factual information, we requested the Commission to tell us what traffic forecast had been used in its calculation. This variable drives some elements of costs and drives revenues. Again, it is a key element in understanding the draft determination. We have not yet received any information.