Maximum Levels of Airport Charges at Dublin Airport

COMMISSION PAPER CP5/2006

Decision of the Commission further to a Referral by the 2006 Aviation Appeal Panel

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1 INTRODUCTION

On the 29 September 2005 the Commission for Aviation Regulation ("the Commission") made its second Determination (the "2005 Determination") in respect of the maximum levels of airport charges that could be levied by the Dublin Airport Authority (the "DAA") at Dublin Airport. The 2005 Determination was made pursuant to section 32 of the Aviation Regulation Act, 2001 (the "2001 Act") as amended by the State Airports Act, 2004 (the "2004 Act").

The Minister for Transport (the "Minister") received requests from two parties to establish an appeal panel in line with the provisions of the Act and accordingly on 9 February 2006, the Minister established an Appeal Panel (the "Panel") to hear the appellants' case pursuant to section 40(2) of the 2001 Act. Subsequently, the Panel decided that one request (from Fáilte Ireland) did not qualify as an appeal under the 2001 Act, the Panel therefore considered only the DAA request.

On 4 April 2006, pursuant to section 40(5) of the 2001 Act, the Panel issued its decision in respect of the 2005 Determination and referred that Determination back to the Commission for review. The decision of the Panel is available on the Commission's website at www.aviationreg.ie

The Panel stated that the matters raised by the DAA in its appeal concerned the reasoning and general approach adopted by the Commission only in so far as they might affect the ability of the DAA to operate and develop Dublin Airport in a sustainable and financially viable manner. The Panel decided, having regard to the Commission's statutory requirement to address this objective, that there were grounds for the Commission to review its price cap allowances in respect of (a) two Capex projects; (b) two adjustments to the Regulatory Asset Base (RAB); and (c) three forecasted commercial revenue streams. The Panel made no mention of any other provision of the Act as being pertinent to its decision and, not having received an appeal from any other parties, considered it unnecessary to seek the views of other parties or the Commission regarding the DAA's appeal.

The Panel's Decision makes various references to a transcript of an oral hearing between the Panel and the DAA. In the interests of completeness and transparency, the Commission requested a copy of the transcript but was unable to procure one as the

Chairperson of the Panel was of the view that it was not possible to accede to the request as there was no Panel *per se* then in existence in order to consider the request. The Commission then sought from the DAA certain clarifications on the matters that were referred to and cross-referenced to the transcript in the Panel's Decision. The Commission is satisfied that the DAA's response provides all of the information necessary to the proper consideration and making of the Commission's Decision further to the Panel's referral.

Pursuant to the referral and to section 40(8) of the 2001 Act, the Commission undertook a review (the "Review") for the purpose of deciding whether or not to affirm or vary the 2005 Determination. Prior to undertaking the Review, the Commission issued CP3/2006 notifying interested parties of the Review and inviting submissions in respect of those matters identified by the Panel as constituting sufficient grounds for referring the 2005 Determination back to the Commission. A list of those matters, together with a description of the scope of the Review was set out in CP3/2006.

The purpose of this Paper is to describe the outcome of the Review and to set out the Commission's decision (the Varied Determination) in relation to affirming or varying the 2005 Determination, and to set out the reasons for the decision in this regard.

Section 2 of this Paper describes the review process, section 3 sets out the decision of the Commission and section 4 sets out the reasons for the decision.

Annex I contains the formulaic representation of the Varied Determination.

Annex II is an explanatory note to accompany the Varied Determination. It contains a number of Tables which set out the Commission's treatment of the key constituents of the price cap having regard to the Commission's decision as set out in section 3. It also includes a table demonstrating how the yields were calculated.

2 REVIEW CARRIED OUT BY THE COMMISSION

The scope of the Review was set out in CP3/2006. The Review was limited to those matters identified by the Panel as constituting sufficient grounds for referring the 2005 Determination back to the Commission.

In carrying out the Review and in making the Varied Determination, the Commission considered the decision of the Panel and the reasons given by the Panel for the referral.

In response to CP3/2006 the Commission received submissions from the following parties: **Aer Lingus**, **bmi**, the **DAA**, **IBEC**, **ITIC**, **Ryanair**, and **SAS** (together the "Parties"). The Commission has considered the submissions of the Parties in carrying out the Review and in making its decision pursuant to Section 40(8) of the Act. In addition, the Commission has had regard to the statutory objectives and the statutory factors set out in Section 33 of the 2001 Act (as amended by the 2004 Act).

Section 33(1) of the 2001 Act, as substituted by Section 22(4) of the 2004 Act, states that: *"in making a determination, the objectives of the Commission are as follows: (a) to facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and prospective users of Dublin Airport; (b) to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport; (c) to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner."* The Commission's interpretation of these objectives was set out in CP3/2005.[1]

The main features of the Commission's view was that economic efficiency continues to be the driving principle of its airport charges determinations and that the three statutory objectives must be read together and in light of each other. This view has not changed and, consequently, is the basis on which the Commission's decision further to the Panel's referral was made.

The Commission is required to "either affirm or vary its original 2005 Determination" (Section 40(8) of the 2001 Act, as amended) and, according to the decision of the High

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[1] CAR (2005), "Maximum Levels of Airport Charges at Dublin Airport: Commission Paper CP3/2005, Determination" 29th September. Available from www.aviationreg.ie

Court arising from the Judicial Review challenge to the Commission's 2001 Determination,[2] is only entitled to consider information that was available at the time of the Determination and not subsequently. Post-determination facts and events cannot be taken into account. The Commission, in carrying out this Review, has, therefore, only taken into account information that was available at the time of the making of the 2005 Determination.

[2] Aer Rianta cpt. v. Commission for Aviation Regulation, 2001 No. 707 J.R. per O'Sullivan J.

3 DECISION OF THE COMMISSION

The Commission has decided to vary the 2005 Determination pursuant to Section 40(8) of the 2001 Act (as amended).

The Commission has identified and set out below the reasons and manner in which the Commission hereby varies the 2005 Determination.

In all other respects, the Commission has decided to affirm the 2005 Determination.

This decision is to vary the 2005 Determination, which entered into force on the 1 January 2006 for a period of four years. Henceforth, the Determination in force is the 2005 Determination as varied by this Decision.

This Decision has the effect of raising the maximum charge that may be levied at Dublin Airport over the four-year period 2006 to 2009 to €6.34 per passenger (in December 2004 prices).

3.1 Reductions in Capital Expenditure (Capex) Allowances

The Commission has varied the 2005 Determination by including in the price cap the full cost of Pier D, that is, the €64m notified to the Commission by the DAA (in the May 2005 CIP) to be the cost of Pier D.[3]

The Commission has not varied the 2005 Determination in respect of the provisional capex allowance of €185.2m for Terminal 2 that is included in the price cap.[4]

3.2 Adjustments to Regulatory Asset Base (RAB)

The Commission has varied the 2005 Determination by restoring to the restated RAB[5] the value of the write-down of Pier C (in the amount of €13.4 m in 2004 prices[6]) that had been excluded from the restated RAB that was used for the 2005 Determination.

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[3] See the data in the Table on p.6 of "Review of Capital Programme", Annex 7 to CP3/2005.

[4] See the data in the Table on p.6 of "Review of Capital Programme", Annex 7 to CP3/2005.

The Commission has not varied the 2005 Determination in respect of the 'claw-back' from the RAB of a capitalised sum (in the amount of €6.6m[7]) relating to income earned on the value of a Pier D asset that was not built.

3.3 Forecasted Commercial Revenues

The Commission has varied the 2005 Determination in respect of the forecast of the DAA's future commercial revenues at Dublin Airport by substituting the DAA's forecasts for future property revenues for those used in the 2005 Determination.

The Commission has not varied the 2005 Determination in respect of the forecasts of the other commercial revenue streams at Dublin Airport that were used in the 2005 Determination.

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[5] I.e. the RAB from 1 January 2006, this being the date at which the 2005 Determination came into effect.

[6] Footnote 46, p.74, CP3/2005.

[7] Page 76, CP3/2005.

4 REASONS FOR THE DECISION OF THE COMMISSION

4.1 Reductions in Capital Expenditure (Capex) Allowances

The Panel decided to refer back to the Commission for review the reductions in allowed Capex.[8] The reductions in question arose as the differences between, on the one hand, the Capex budgets sought by the DAA in respect of an additional pier at Dublin Airport (Pier D) and a second passenger terminal (Terminal 2, or T2) and, on the other, the lower provisional allowances for these projects used by the Commission to calculate the 2005 price caps[9].

The Panel considered separately the Capex allowances in regard to Pier D and T2.

4.1.1 Pier D

Concerning Pier D, the Panel criticised the Commission's reduced Capex allowances, which it described as unreasoned, arbitrary and illogical. Second, the Panel considered that the cost of delaying the project, in order to develop a different specification for the facility, would be more expensive at this advanced stage than to proceed to build the current specification for which planning permission has been obtained. Third, the Panel considered that, in any case, the Commission has no role in evaluating matters such as the design and configuration of airport facilities. Finally, the Panel expressed a concern that *"the Commission believes that DAA will always significantly overestimate its investment costs and that the appropriate regulatory response is to adjust these estimates downwards by a significant amount no matter how limited the available evidence on the magnitude of the perceived bias."* [10] The Panel considered that this approach, which it said the Commission adopted, was out of line with best practice incentive regulation. For these four reasons, the Panel referred the Pier D Capex allowance back to the Commission for review.

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[8] Paragraph 6.3.14 of the Panel's decision.

[9] These differences, on their own, had the effect of reducing the price cap by approximately 18 cents. The average (over the period of the Determination) price cap set by the Commission was €6.14 per passenger (in December 2004 prices).

[10] Paragraph 6.3.7 of the Panel's decision.

Following its publication of the Panel's decision, the Commission sought views from airport users and other interested parties on the three matters that had been referred back to the Commission. Submissions on the Pier D issue were received from Aer Lingus, Bmi, the DAA, IBEC, ITIC, Ryanair and SAS.[11]

Bmi supported the Commission's approach to Pier D Capex; **Ryanair** said the approach was entirely justified by the history of the former Aer Rianta's airport investment record; **SAS** questioned why charges should rise until the new CIP was finalised and agreed.

Aer Lingus stated that its position had changed from opposing (at the May 2005 consultation stage) the inclusion in the price cap of the costs of Pier D, to one of now supporting their inclusion, on the grounds of there being no alternative way, in its view, to add pier capacity in the short term except to proceed with the current plan for Pier D. Aer Lingus considered that airport users would suffer greater losses from further delays to, or cancellation of, Pier D than from proceeding with the current design and specification, despite its shortcomings.

ITIC supported the Panel's criticisms of the Commission's approach to Pier D, judging it illogical and petty. **IBEC** expressed similar views; it entirely supported the Panel's decision and endorsed its claims of Commission bias against the DAA. IBEC depicted airport regulation as dysfunctional and suggested that this problem merited action by the Minister for Transport and the Government.

On behalf of the **DAA**, NERA considered that the best response by the Commission to the Panel's decision would be to reverse in full the adjustments made to the DAA's Capex budgets, and use the DAA's Capex figure for Pier D in calculating the price cap.

Following careful consideration of the Panel's decision, and also of the submissions received, the Commission has varied the 2005 Determination by including in the price cap the full cost of Pier D, that is, the €64 m notified to the Commission by the DAA (in the May 2005 CIP) to be the cost of Pier D.[12] The Commission's reasons for its decision are as follows.

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[11] The full text of these submissions have been placed on the Commission website www.aviationreg.ie.

[12] See the data in the Table on p.6 of "Review of Capital Programme", Annex 7 to CP3/2005.

The Commission does not accept the Panel's characterisation of the Commission's approach to setting its 2005 provisional Capex allowances. The Commission's reasons for not accepting the Panel's views on its approach to Capex are set out in section 4.1.3 below.

The Commission notes that the Panel's role and powers are contained in section 40 of the 2001 Act. This provides that an Appeal Panel: *"… shall consider a determination and … may confirm the determination or, if it considers that in relation to the provisions of section 33, there are sufficient grounds for doing so, refer the decision in relation to the determination back to the Commission for review."* The Panel's powers are thus limited to deciding whether or not to refer back to the Commission for review a determination that has been appealed to the Panel, by reference to section 33 of the Act.

The Panel itself in its Decision at paragraph 5.1 has accurately identified the nature of its remit where it referred to its "limited role and functions under the legislation". Hence, in the Commission's view, any wider observations that an Appeal Panel might make - e.g. in the case of Capex, on whether an independent regulator should evaluate the specifications of airport facilities, or what constitutes best practice in investment regulation – would appear to be outside the remit intended by the Oireachtas for the appeal phase of the process. Although the Panel has no prescribed role in making recommendations as to best practice regulation, given the divergence between the Commission's understanding and the views expressed by the Panel, the Commission has considered it important in the interests of accuracy and balance to make brief reference to whether best-practice incentive regulation of investment requires uncritical acceptance in good faith of a regulated firm's Capex. This matter is addressed in section 4.1.3 of this Decision.

Additionally and more significantly, in the interests of reminding interested parties and the public of the legal context in which it conducts its business, the Commission wishes to point out that its statutory role in the area of Capex has been the subject of very lengthy consideration by the High Court as part of the Judicial Review action taken by the former Aer Rianta (now the DAA) against the Commission's 2001 Determination.

It is unknown to the Commission whether the Panel had an opportunity to review the Court's Decision in that matter; however, given its significance for the work of the Commission, it is important that the findings of the Court be revisited in this Paper. In

its Judgment the High Court made a very clear pronouncement as to the role and remit of a regulator in relation to the capital expenditure plans of the regulated company. By way of answering the question**:** does the respondent have the power to review the applicant's Capex, Mr. Justice O'Sullivan stated:

"It is in principle inimical to the concept of regulation that the Capex which is an element going to make up the charges should be beyond the control of a regulator in a way analogous to the repugnancy of the notion that a Minister with power of approving charges should somehow end up only as a rubber stamp. It is not surprising, therefore, to find in the Act of 2001 an explicit amendment of the Act of 1998, which provides that the power of the applicant to determine charges is to be subject to section 32 of the Act of 2001. The role of the Minister who had power to approve (and therefore disapprove) the charges is now replaced by section 32 of the Act of 2001. Section 32 sets out the entire mechanism and jurisdiction exercised by the respondent in performing his principal function of regulation. It includes power to specifically reject (or accept) any representation made by an interested party pursuant to a statutory consultation process and thereby in explicit terms subjects any determination of airport charges by Aer Rianta for the purposes of enabling it to discharge its duty under s.16(2) to the possibility of outright rejection by the respondent.

The effect of the relevant statutory provisions, therefore, appears to be that the CAR, in carrying out its duties of regulating airport charges, has a positive duty to aim to facilitate the development of cost effective airports and while so doing must have due regard to the level of investment in the subject airport and is specifically equipped with a power to reject any proposals in relation, inter alia, to CAPEX that may be submitted to him by the operations of that airport. Moreover there is nothing in the provisions of the Act of 1998 which would upset or overturn this conclusion, rather the contrary, because the statutory duties to ensure the provision of services cast upon the applicant in s.16(2) and its powers under the s.39 to determine charges is specifically made subject to those general and specific powers of the respondent which include the power to reject their proposals on CAPEX." [13]

In light of this very clear pronouncement by the High Court as to the role and remit of a regulator in relation to the capital expenditure plans of the regulated company, the

[13] Aer Rianta cpt. v. Commission for Aviation Regulation, 2001 No. 707 J.R. per O'Sullivan J.

Commission is obliged to disagree with the Panel's view that it is not for the Commission to adjudicate upon the design and configuration of airport facilities as part of the regulator's assessment of the capital expenditure plans of the regulated firm.

In relation to the specific issue of the Pier D capex allowance, the Panel considered that the cost to airport users of delaying the delivery of Pier D, including for the purpose of developing a different specification for the facility, would be more expensive at this advanced stage than to proceed to build the specification for which planning permission has been obtained.

In the Commission's view the provision of airport capacity can lead to excessive costs for airport users in a number of different ways. If airport facilities are provided too early, and included in the calculation of airport charges, users pay charges that are excessively high. If airport facilities are provided at the right time but at excessively high unit costs, or are built to a specification that is much higher than users wish to use and are willing to pay for, the airport charges that users pay are too high. If airport capacity is provided too late, even though airport charges do not change, airport users are exposed to congestion costs, such that the sum of airport charges and congestion costs are excessively high. Congestion costs may take the form of time costs (delays) as well as crowding and other discomfort.

In the Commission's judgement, a further delay in the delivery of Pier D would, in the current circumstances at Dublin Airport, be very likely to lead to congestion and delay costs for airport users in excess, and perhaps considerably in excess, of the possible financial saving to users (in the form of airport charges lower than otherwise) arising from a redesign of Pier D. Moreover, as noted by the Panel, [14] a redesign of Pier D would give rise to its own costs [15] leaving the net financial impact on airport charges somewhat uncertain. The Commission has accepted this ground for review offered by the Panel argument and has varied its allowance to Pier D Capex for that reason.

In conclusion, the Commission identifies four grounds in the Panel's Decision on which the Commission should review its Capex allowances for Pier D. The Commission considered two of the four grounds – concerning a regulator's role in evaluating airport

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[14] Paragraph 6.3.3 of the Panel decision.

[15] In the forms of engineering and architectural costs, a new planning application, and discussions with users.

facilities and whether a regulator should assume that a firm's Capex forecasts are biased upwards - to be outside of the intended remit of the appeal phase of the process. A third ground was based on a mis-characterisation of the Commission's approach, and has been rejected by the Commission. (See section 4.1.3.) The Commission has accepted the fourth ground: that further delay to Pier D even if it produced a cheaper specification (and that is uncertain) would impose higher overall costs on airport users. For that reason, the Commission has varied its Determination in respect of the Capex allowance for Pier D.

4.1.2 Terminal 2

Concerning T2, the Panel noted that the Commission's Capex allowance was based on a T2 facility that was some 40% smaller in size (square metres) than that sought by the DAA. The Panel considered that even the space requirements corresponding to the T2 budget sought by the DAA appeared relatively conservative compared to international benchmarks. The Panel accepted that the Commission's approach to Capex allowances for T2 was *"necessarily of a provisional nature, given the significant uncertainties about likely costs that remained at the time of the determination. We are therefore of the view that it was reasonable for the Commission to err on the side of caution in the inclusion of future expenditures in the determination, at least until better information became available."* [16] However, the Panel considered that there was considerable risk in linking the provisional Capex allowance to such particulars as facility size and cost benchmarks, including an increased assessment of regulatory risk by capital markets. For these reasons, the Panel referred the T2 Capex allowance back to the Commission for review. The Panel also recommended that the timing of a Commission review should be *"at such time as some of the major uncertainties have been resolved … [but] in the interim … the Commission decision to reduce the size of the terminal is arbitrary and illogical and … the Commission should review same."* [17]

The Commission feels obliged to state that the Panel's grounds for recommending that the Commission vary the T2 Capex allowance are not easily reconciled with the Panel's remarks on the provisional nature of the Commission's allowance and on the timing of a review.

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[16] Paragraph 6.3.12 of the Panel's decision.

[17] Paragraphs 6.3.13 and 6.3.14 of the Panel's decision.

Following its publication of the Panel's decision, the Commission sought views from airport users and other interested parties. Submissions on the T2 issue were received from Aer Lingus, Bmi, the DAA, IBEC, ITIC, Ryanair and SAS. [18]

Ryanair, Bmi and **SAS** repeated the comments they had offered on the Pier D allowance. **bmi** supported the Commission's approach, which Ryanair said was entirely justified; SAS questioned why charges should rise until the new CIP was finalised and agreed.

ITIC expressed dismay at the reduced allowances for T2, describing them as arbitrary, absurd, foolish and unconscionable. **IBEC** supported the Panel's comments that the Commission had no role in evaluating the design and configuration of airport facilities.

Aer Lingus stated that the Commission had been correct to make only a provisional allowance at a time when so little detail about the facilities that T2 would offer airport users had been known. Nonetheless, at this stage, Aer Lingus has no objection to the Commission accepting the Panel's recommendation that the T2 allowance be reviewed. Aer Lingus believes that T2 will need to be specified on a larger scale that that used by the Commission for the 2005 price cap. Moreover, Aer Lingus would like to see the Commission give a signal that it will be supportive of the long-term expansion of capacity at Dublin Airport, though without necessarily committing itself to funding any particular level of Capex.

On behalf of the **DAA**, NERA considered that the best response by the Commission to the Panel's decision would be to reverse in full the adjustments made to the DAA's Capex budgets, and use the DAA's Capex figure for T2 in calculating the price cap.

After careful consideration of the Panel's decision and of the submissions received, the Commission has not varied the 2005 Determination in respect of the provisional Capex allowance of €185.2m for Terminal 2 that is included in the price cap. [19] The Commission's reasons are as follows.

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[18] The full text of these submissions have been placed on the Commission website www.aviationreg.ie

[19] See the data in the Table on p.6 of "Review of Capital Programme", Annex 7 to CP3/2005.

While faulting the use by the Commission of certain benchmarks to determine the provisional Capex allowances, the Panel nonetheless accepted the reasonableness of setting a provisional allowance (at least in respect of Terminal 2), stating:

"The Panel notes that the Commission's approach to CAPEX allowances for Terminal 2 was necessarily of a provisional nature, given the significant uncertainties about likely costs that remained at the time of the determination. We are therefore of the view that it was reasonable for the Commission to err on the side of caution in the inclusion of future expenditures in the determination, at least until better information became available." [20]

This statement accurately describes the Commission's motivation in 2005.

The Panel suggested that a review of this matter should be undertaken when some of the major uncertainties have been resolved. The Commission signalled in the report of the 2005 Determination that it (also) believed that it might be appropriate to review the Determination once it has had time to fully consider the finalised capex programme proposed by the DAA. This remains the Commission's position and current thinking. The Commission has commenced its consideration as to whether substantial grounds exist to warrant a Review of the 2005 Determination. On completion of this analysis, the Commission intends to publish a Commission Paper setting out its conclusions and seeking the views of interested parties.

In conclusion, the Commission considers that the Panel has offered two grounds on which the Commission should review the Capex allowance for T2: the insufficiency, in the Panel's view, of the space requirement underlying the Commission's allowance, and the danger (including increased regulatory risk) raised by linking the allowance to particulars such as size and cost benchmarks. The Commission has decided not to vary its decision in regard to the provisional Capex allowance for T2. This is because of the significant uncertainties (as accepted by the Panel) about likely costs and also because the Commission continues to consider that size and cost benchmarking provide a reasonable basis for provisional Capex allowances until such time as final information is available from the DAA.

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[20] Appeal Panel Decision, para 6.3.12

4.1.3 The Commission's Approach to Capital Expenditure Allowances

The Commission considers that it would be helpful to restate here the basis of its decision and reasoning on Capex issues. In addition, the Commission has set out its views on whether best-practice incentive regulation of investment requires uncritical acceptance in good faith of a regulated firm's Capex.

The Panel criticised the Commission for undertaking a top-down review of the DAA's Capital Investment Plan (CIP) and, in particular, for setting a provisional Capex allowance with reference to such benchmarks as the existing piers and terminal at Dublin Airport. This Commission is satisfied that this review was warranted to protect airport users in relation to a capital programme that had neither been adequately evidenced by the DAA nor received the consent of users. The Commission was and remains very alive to the pressing need for new capacity at Dublin Airport, and considered it necessary to reflect that in the 2005 Determination. Additionally this matter was the subject of a Ministerial Direction to the Commission prior to the making of the 2005 Determination. The top-down assessment was intended to be a cautious assessment of what level of capital expenditure could be justified notwithstanding the lack of information from the DAA or consent from users. That caution was balanced by a commitment to consider carrying out a more thorough review when the investment plans were better developed.

The provisional character of the Capex allowances included in the 2005 Determination was highlighted in the Foreword to that Determination. After noting its support for the provision of cost-effective and timely investment at Dublin Airport, the report explained that, given the statutory timeframe, the Commission had decided to make an allowance in respect of the costs of the DAA's investment plan, which could be reviewed after finalised Capex information became available.

Accordingly, the Foreword to the report of the Determination contained the following statements:

"A key driver of this Determination is the implementation by the DAA of the Government's Aviation Action Plan of May 2005 ("Aviation Action Plan") and the delivery of cost effective capacity at Dublin Airport in a timely manner. Following the adoption of the Aviation Action Plan, the DAA has been involved in a review of its capital investment programme … The Commission fully supports this review and consultation process ...

However, as a result … the DAA has been delayed in the delivery of its finalised capital expenditure (capex) programme to the Commission … Unavoidably, the Commission has not had the time to analyse the revised DAA capex programme against the statutory objective of economic efficiency … It is within this context that this Determination has had to be produced in order to comply with the statutory timeframe. The Determination has included an allowance for the efficient development of infrastructure at Dublin airport based on an independent assessment of the DAA Capital Investment Programme delivered to the Commission in May 2005. This includes funding for a second terminal and additional pier capacity … The Commission believes that it may be appropriate to review the Determination once it … [has] had time to fully consider the finalised capex programme proposed by the DAA. Accordingly, this Determination may be subject to review in the short to medium term." [21]

In the body of the Report on the Determination, the Commission described the Capex allowance as follows:

"the Commission has made an independent assessment of the company's May 2005 CIP and provided an allowance in the price cap for an indicative capex programme based on the analysis by its consultants" [22]

The report of the Commission's consultants likewise emphasised the provisional nature of their own conclusions:

"DAA emphasised to the Commission that the [May 2005] CIP was not a final plan and, in the late stages of writing of this report … although it has been provided with a recommendation report prepared by DAA's advisors, Pascall & Watson, the recommendation report does not include the level of detail of methodology and analysis necessary to support the size, location, specification and sequencing of major capacity-driven projects. It will be necessary to reappraise our findings in the light of detailed justification.

…Our top down analysis is not sufficient by itself to provide a safe basis for a firm capital expenditure needs assessment covering a control period of four or five years. It may

[21] Foreword to the Commission's 2005 Price Determination, CP3/2005, p.3-4

[22] CP3/2005, p.59

provide the basis for a provisional assessment provided there is an expectation it will be supplemented with a more considered bottom-up assessment after this review." [23]

The consultants' suggestion that their report should "help identify the principal issues for the Commission to explore with DAA before reaching any supplementary conclusions on the capital programme after this review" [24] duly foreshadowed what has since occurred.

The Commission's wish to support airport Capex was also illustrated by its express rejection of Ryanair's proposal that the Capex costs of Pier D and Terminal 2 be totally excluded from the price cap calculations until certain criteria would be met:

"Ryanair's request to have the DAA's capex programme excluded from the current Determination, including funding for a second terminal, until the airport achieves agreement from the majority of users that the projects are necessary and the costs are not excessive, is rejected because of the real and growing capacity deficits at Dublin Airport. Such a policy would not, in the Commission's view, balance with the needs of the Airport to be able to invest to develop and grow. Nor would it balance with the needs of users, whose growing dissatisfaction as the expected delivery date for new capacity approaches would not be optimally met by imposing funding problems on the airport."[25]

Against this background therefore, the Commission does not accept the Panel's general dissatisfaction with the Commission's approach to determining Capex allowances.

In paragraphs 6.3.7 and 6.3.8 of its Decision, the Panel expresses certain views on best-practice regulation of investment. The Panel states a concern that the Commission believes that the DAA will always significantly over-estimate its investment costs, and that the Commission believes that the appropriate regulatory response is to adjust those estimates downwards by a significant amount. The Panel considers that such an approach is a disincentive for good faith conduct by DAA. The Panel also asserts that to assume an upward bias in the company's Capex figures would be out of line with best practice incentive regulation. The Commission is not persuaded by the Panel's views that the Commission's approach to Capex should be based on an uncritical assumption of

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[23] 'Review of the Capital Programme', IMR/WHA, Annex 8, CP3/2005, quotations from opening paragraph and from p.7

[24] Review of the Capital Programme, p.7

[25] CP3/2005, p.60

good faith on the part of the regulated entity in relation to its Capex forecasts. The Commission's reasons for so thinking are set out below.

In 2001, the Capex Programme of the former Aer Rianta contained a number of projects (for example, an internal rail link with a budget of circa €130 million) to which no subsequent reference has been made. There were also a number of projects, the timing of which have been substantially pushed back in the company's May 2005 CIP. This was compounded by the inability of the company, in 2001, to produce evidence of adequate and effective consultation on such projects, or any business cases/financial justification for the projects, or any cost-benefit analyses of the projects or competing options for delivering them. A concern that the Commission was obliged to address therefore was its previous experience with the former Aer Rianta in relation to this issue.

The opinion of the High Court in relation to this general issue is also worth noting here. The Court stated the following in relation to the Commission's role:

" In my specific view there is a specific duty on the respondent to review a subject airport's capex. This applies even if the subject airport fails to provide information in relation to such capex or insufficient detail for the purpose of the respondent's analysis…"

"As already stated, in my opinion the respondent was, if not obliged certainly authorised by the specific provisions of s.33 to carry out an item by item analysis and review of the applicant's CAPEX with power to allow, disallow or reduce same…" [26]

The view that regulated companies have an incentive to exaggerate their Capex costs is widespread in the regulatory literature and indeed is commonly regarded as a simple deduction from the two facts: (i) that companies are generally motivated by profits and (ii) that profits are increased if a regulator sets a price cap at a level sufficient to finance a given capital budget but the firm under-spends on capex while continuing to attract the envisaged level of sales.

The Commission's presumption that a regulated firm's data need to be evaluated with a due degree of scepticism is shared by a recent note [27] on the subject of 'truth telling' in

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[26] Aer Rianta cpt. v. Commission for Aviation Regulation, 2001 No. 707 J.R. per O'Sullivan J.

Capex, prepared by Mr. Graham Shuttleworth, a Director of NERA. The reference to 'truth telling' arises because Mr. Shuttleworth considers, contrary to the views of the Panel, that 'good faith' cannot be assumed to apply when this might be contrary to a firm's private interests.

Mr. Shuttleworth's paper asks how regulators should assess companies' investment plans. He does not advocate a presumption of good faith but instead describes how in the last review of the UK electricity network, the UK energy regulator (Ofgem) incorporated a new technique to encourage truth telling, based on economic theory, where "the challenge facing Ofgem (and any energy regulator) is to encourage regulated companies to spend money efficiently – not just to cut costs, and not just to spend freely."

Mr. Shuttleworth concludes that it "is probably a productive use of a regulator's time" for the regulator to argue with the regulated company about the amount of capex to allow in future.

Therefore, on grounds of the 2001 record, economic logic, and standard regulatory practice, the Commission has not accepted the Panel's view that the Commission's approach to Capex should be based on an uncritical assumption of good faith by the DAA's in preparing its Capex plans.

4.2 Adjustments to Regulatory Asset Base (RAB)

4.2.1 Pier C Write-down

Concerning the Pier C write-down, the Panel expressed the concern that reductions in the RAB of that nature could create adverse regulatory risk and uncertainty and could, without guidance from credible and legitimate principles, be perceived as a form of capital expropriation. The Panel also discussed circumstances in which it would consider RAB disallowances to be legitimate. Finally, the Panel argued that if Pier C costs were permanently removed from the RAB because the former Aer Rianta did not formally appeal this aspect of the first Determination to the last Appeal Panel, the Panel does not believe that DAA are 'estopped' from contesting the decision now.

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[27] "Setting incentives for truth-telling and efficiency", Graham Shutttleworth, paper in 'Power UK', issue no.140, October 2005, issued via www.platts.com.

On foot of publication of the Appeal Panel's decision and the invitation to consult, submissions on the issue of the Pier C write-down were received from Aer Lingus, bmi, IBEC, ITIC and Ryanair.

Aer Lingus expressed the view that the decision to [continue to] disallow expenditure in respect of Pier C sets a difficult regulatory precedent that might discourage the DAA from developing future capacity. For this reason, and because the then Aer Rianta obtained approval by its regulator at the time (the Minister), Aer Lingus (reluctantly) agrees with the Appeal Panel that expenditure in respect of Pier C should not [continue to] be disallowed. **IBEC** regarded the RAB disallowances by the Commission as unreasonable "having regard to the behaviour of DAA and the particular challenges and uncertainties it confronts in advancing large scale capital projects."

bmi supported the Commission's approach to the disallowance of costs that have been independently determined as excessive, while **Ryanair** expressed the view that the Commission was entirely justified in reducing the regulatory value of the Pier C facility, but that the reduction should have been even greater because Aer Rianta had ignored the reasonable interests of users. Furthermore, Ryanair supported the notion that stranded assets based on imprudent investment must remain stranded because otherwise users end up paying for the regulated monopoly's mistakes.

NERA, on behalf of the **DAA**, considered that the only way the Commission can reflect the Panel's decision is to fully reinstate the previously disallowed expenditure on Pier C and, moreover, that a partial reinstatement is not an option as this would be inconsistent with the clearly stated views of the Panel.

Following careful consideration of the Panel's decision, and also of the submissions received, the Commission has varied its 2005 Determination by restoring to the RAB the value of the write-down of Pier C (in the amount of €13.4 m in 2004 prices) that had been excluded from the restated RAB that was used for the 2005 Determination. The Commission's reasons for its decision are as follows.

4.2.1.1 Rationale for the Commission's 2001 Decision

First, the Commission notes that the majority of the Panel's and, indeed, consultees' comments on this issue are expressed as a challenge to the Commission's 2001 decision to write down the value of Pier C. For the sake of completeness and to facilitate a full

understanding of the rationale for its decision to reverse the permanency of the Pier C write-down, the Commission has decided to recap on its rationale for the original 2001 decision prior to proceeding to deal with the issue for the 2005 Determination of permanency.

In constituting and valuing the Regulatory Asset Base for the purposes of its 2001 Determination, the Commission adjusted downwards the value of Pier C by 22.6 per cent in order to take account of what it considered to have been "imprudent investment" at Dublin Airport. The underlying policy rationale for the adjustment was first articulated in the Commission's 2001 Draft Determination, where it acknowledged that[28] *"…the requirement for an examination of the assets that are necessary for the sustainable provision of airport services and that, therefore, will require replacement in the future. It is these assets that should be included in the RAB"* and that *"For the purposes of the draft determination, the Commission has…attempted to define the RAB on the basis of existing assets, excluding those assets, the replacement of which in the future is not critical to the sustainable operation of Aer Rianta's airports."*

As also outlined in the 2001 Draft Determination, the Dublin Airport RAB adjustment was designed to reflect the value of a hypothetically efficient equivalent to Pier C. The motivation for this specific adjustment was claims by airline users of imprudence on the part of Aer Rianta in undertaking that investment. For example, in its response to the Commission's first consultation paper [29] on the economic regulation of airport charges, Aer Lingus stated as follows:[30] *"There are many examples of inefficient investment on the part of Aer Rianta. In virtually all cases the inefficiency was as a direct result of the lack of consultation with airport users."* Aer Lingus then proceeded to give examples of inefficiencies, including *"the cost, design and development of Pier C at Dublin Airport."*

Ryanair, in its response to the same consultation paper, stated that: *"Examples of 'gold-plating' abound at the regulated airports…"* and pointed to *"…Aer Rianta's tendency to develop costly and inefficient facilities, such as Pier C, the six-bay extension…"*. Ryanair

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[28] See CAR (2001), "Proposed Maximum Levels of Airport Charges: Draft Determination and Explanatory Memorandum", Commission Paper CP6/2001, pp. 8-9.

[29] See CAR (2001), "Economic Regulation of Airport Charges in Ireland: Consultation Paper on the Maximum Levels of Airport Charges that may be levied by an Airport Authority under the Aviation Regulation Act, 2001", Commission Paper CP2/2001.

[30] See Aer Lingus response to CP2/2001, pp. 12-13. Available from www.aviationreg.ie.

also pointed to the lack of meaningful consultation and consensus amongst airport users: *"This lack of consensus was recently highlighted by the refusal of both Aer Lingus and Ryanair to move into the new 6-bay terminal extension or Pier C. In addition, the development of Pier C has led to a facility that is completely inefficient and only caters to less than 18% of the airport's throughput, despite its extremely high cost. On the other hand, Aer Rianta is refusing to build Pier D, which was initially planned and designed by them and has received planning permission."*

In its response to the Commission's 2001 Draft Determination, Ryanair went further and expressed the view that [31] *"The cost of Pier C must be written down to £15 million for valuation purposes, which equates to the cost of a "cost effective" pier that would meet the requirements of users, had it been designed along the lines of the agreed Pier D."*

On foot of these comments, it was clear that certain past investments by the company did not meet the needs of users and may have involved elements of 'gold-plating'. The Commission was, therefore, motivated to signal to the industry that a return on or of the capital costs of such investments could not be expected to be necessarily recoverable through regulated airport charges. This resulted in an adjustment downwards of the opening RAB to reflect the value of the portion of the Pier C investment deemed to have been imprudent. This was consistent with the underlying policy rationale first articulated in the Commission's 2001 Draft Determination and was consistent with standard regulatory practice in Ireland and abroad.

4.2.1.2 The Commission's 2005 Decision

The issue for the Commission's second determination was, in rolling forward the value of the RAB, whether adjustments made in the initial valuation of the RAB for imprudent investment should be reversed or fixed as a permanent adjustment. In its 2005 Draft Determination, the Commission explored the possibility that restoration to the RAB of the value of investments deemed to be imprudent in 2001 might be justified on the grounds that such investments should be treated symmetrically to opex efficiencies, which the company retains for up to 5 years. In other words, if the company only has a few years' worth of reward for efficiency, it should also only have a few years' worth of penalty for inefficiency. However, Aer Lingus and Ryanair opposed any reversal of the 2001 adjustment, as, they considered, to do so would encourage the airport operator to

[31] See "Ryanair's Submission Regarding the Commission for Aviation Regulation's Draft Determination (CP6/2001)", 26 July 2001. Available from www.aviationreg.ie.

make excessively costly, or gold-plated investments. Ryanair also pointed again to the lack of consultation by the DAA in arriving at its capital investment programme. Therefore, on foot of these representations and on foot of evidence of a continuing problem of inadequate user consultation and costings for investments that appeared excessive and lacked value-for-money, the Commission decided to fix the Pier C RAB adjustment permanently, stating the consistency of this policy with a high-powered incentive scheme mandated by the Government's Aviation Action Plan.

In other words, the Commission was of the view that fixing the Pier C write-down was required to signal, in the context of the company undertaking a substantial investment programme, that a policy of substituting actual-for-forecast capex would not necessarily be automatic when the Commission comes to roll forward the RAB for the purposes of future price reviews. For example, were the Commission still regulating Cork Airport, the treatment of the outturn capex costs for the new Cork Airport terminal would raise very difficult questions regarding a policy of substituting actual-for-forecast capex given that the Commission understands that the new terminal has suffered substantial cost overruns for a facility that delivers less than originally intended.

The Commission continues to be concerned about the efficient delivery of Capex but has decided to investigate alternative and better ways of providing incentives for such efficiency, rather than trying to implement these incentives by fixing the Pier C write-down. As it no longer believes that permanently fixing the Pier C write-down is the best way to incentivise capital investment efficiency, the Commission has decided to restore the write-down to the restated RAB from 1 January 2006. Therefore, the Commission's principal concern in reversing the permanency of the Pier C write-down is the availability of alternative means of incentivising the efficient management and delivery of its Capex programme in the future.

Concerning the circumstances in which the Panel would consider RAB disallowances to be legitimate, the Commission considers this issue to be in the nature of regulatory policy and as such the observations remarks by the Panel appear in the Commission's view to be outside the intended remit of the appeal phase of the process. Moreover, in the course of the High Court[32] case already referred to, the former Aer Rianta argued

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[32] Aer Rianta cpt. v. Commission for Aviation Regulation, 2001 No. 707 J.R. per O'Sullivan J.

that if the court held that the Commission had jurisdiction to review CAPEX, then in doing so the Commission must be constrained in the following ways:

1. that the Commission can only review CAPEX and projects within it on the grounds of unreasonableness … thus giving [the airport authority] a proper margin of appreciation
2. the Commission may not micro-manage or micro-analyse the applicant's CAPEX in the sense of purporting to disallow individual projects within it as distinct from imposing an overall cap thereon.
3. the Commission may not substitute its own CAPEX on the advice of his consultants for that of the applicant.
4. the Commission may not, without more, exclude projects in the applicants CAPEX on the basis that the applicant has failed has failed to justify them or on the basis that there has been insufficient consultation with airport users in respect thereof.

The Court answered that it could:

"find no warrant in the language of the Act of 2001 to support the proposition that the respondent may only interfere with the applicant's CAPEX in so far as he finds it to be unreasonable. No such limitation appears attached to the concept of regulation itself in section 7. The language of s.33 requires the respondent to aim to facilitate the development of cost effective airports which meet the requirements of users and insofar as the subject airports CAPEX is involved gives the respondent a far more intrusive relationship to it than that connoted by the concept of irrationality review.

[The Commission] must in my view, test and measure the CAPEX by reference to this overall aim and this in turn involves assessing whether the CAPEX or any particular element in it is conducive to that aim. If the applicant's submission on this point is correct then he must simply pass through the CAPEX unless he finds it irrational regardless of whether it facilitates such an aim or not. Such an interpretation would require specific language, which is not present. On the contrary, in my view, the CAR when dealing with the specified and shall have regard to the ten matters listed in section 33. The manner in which he carries out his duties insofar as the applicant's CAPEX in concerned is set out comprehensively, albeit in fairly general language in s. 33 which require him to carry out an assessment and evaluation of the capex by reference to the statutory criteria."

The Panel considers that the circumstances under which RAB disallowances might legitimately be justified would be the event of some manifest deficiency in the performance of the regulated company, such as would be considered to be outside normal commercial parameters. However, in the light of High Court judgment referred to above, the Commission believes it is entitled to test and measure investment at Dublin Airport by Dublin Airport Authority by reference to its three statutory objectives and the various factors to which it must have due regard and this in turn involves assessing whether the capital investment or any particular element in it is conducive to those objectives.

4.2.2 Pier D Clawback

Concerning the Pier D 'claw-back', the Panel expressed the view that the policy was inconsistent with the 'standard' approach to CPI-X regulation (which the Commission indicated that it is seeking to follow) because, under that approach, (1) projected expenditures are not linked to particular projects or project outcomes in recognition of the fact that, in general, things will not go exactly to plan and flexibility to adjust plans is to be positively encouraged; and (2) 'claw-back' is equivalent in economic effect to retrospective, discretionary adjustment of charges that were intended, and promised (under the 'standard' approach) to be pre-determined. The Panel also stated that it did not seek to imply that the Commission necessarily had to follow the 'standard' approach and highlighted a number of alternative options.

The Panel also discussed circumstances in which 'claw-back' could properly be considered legitimate. The Panel considered that 'claw-back' should only be contemplated in circumstances in which there has been prior and manifest "non-compliance" by the company, where non-compliance does not simply mean deviating from the plan because it is rare that the assessed CIP will actually be delivered nor operating inefficiently because most companies in most markets operate in ways that fall short of maximum efficiency.

The Panel also considered that the Commission appears to have applied the approach of 'claw-back' selectively and may, via retrospection focussed only on investment activity, signal a negative regulatory attitude to CAPEX to the investment community. The selectivity of the policy, the Panel claimed, is illustrated by the fact that the Commission's first Determination was based on projections of DAA commercial revenues that did not materialise and which were to the benefit of users, but which were not

subjected to retrospective adjustment. Finally, the Panel considered that retrospective adjustments, such as clawback, almost invariably give rise to regulatory uncertainty.

On foot of publication of the Appeal Panel's decision and the invitation to consult, submissions on the issue of the Pier D 'claw-back' were received from Aer Lingus, bmi, IBEC, ITIC and Ryanair.

Aer Lingus expressed the view that, if investment has been funded through regulated airport charges, then the *"threat of clawback is essential to ensure that the airport delivers the outputs for which the money is intended"* but was minded to note that this principle should, in most cases, apply regardless of whether events leading to the clawback were within the control of the regulated firm. Aer Lingus also expressed the view that *"if investment is allowed without any measure of the outputs that are expected in return and without any possibility that the funding can be withdrawn if the outputs are not delivered, then a regulated company has a strong incentive to cut quality and fail to deliver outputs once the regulatory settlement has been finalised"* and that *"if this money were not removed from Dublin Airport's RAB then this would a) signal to DAA that it was in its commercial interest to obtain capacity funding from the Commission and then not deliver that capacity and b) mean that DAA would be paid twice for the same Pier development."* **Ryanair** and **bmi** echoed these sentiments.

The **ITIC** expressed the view that the clawback was unreasonable given *"widespread acknowledgement of the fact that the delay in commencing Pier D was not caused by the DAA"*, given that the project is now going ahead and given that the Commission's approach to clawback was applied selectively. **IBEC** stated that the clawback was unreasonable having regard to the behaviour of the DAA and the particular challenges and uncertainties it confronts in advancing large-scale capital projects.

NERA, on behalf of the **DAA**, considered that the only acceptable response to the Panel's decision is a full reversal of the clawback and that any other course of action would significantly undermine the perceived effectiveness of the existing appeals mechanism.

Following careful consideration of the Panel's decision, and also of the submissions received, the Commission <u>has not varied</u> its 2005 Determination in respect of the 'claw-

back' from the RAB of a capitalised sum (in the amount of €6.6m[33]) relating to the costs of a Pier D that was not built. The Commission's reasons for its decision are as follows.

The Commission notes the conventional wisdom that there are two broad approaches to setting price controls. One is a price cap, which, in its purest form, involves setting maximum charges for an extended period without reference to the firm's costs or volumes, but rather with reference to industry yardsticks. It is the Commission's understanding that this is the 'standard' approach to CPI-X regulation referred to by the Panel. The other is a cost passthrough, which sets charges based on the firm's actual costs and often involves ex post revenue adjustments to exactly match those costs. The conventional wisdom is also that the price cap provides more powerful incentives for cost minimisation and efficiency than the cost passthrough. In practice, however, price caps are predominantly a hybrid of the pure price cap and the cost pass-through methodology, precisely because of the difficulty in identifying reliable industry yardsticks and the consequent need to rely on the recorded and projected costs of the regulated company.[34]

The Commission's price cap on airport charges at Dublin Airport is based on a hybrid methodology. Consequently, the Appeal Panel's commentary does not reflect the nature of the Commission's stated policy in respect of CAPEX. In respect of the provision of a fourth pier facility at Dublin Airport, the Commission stated in its 2001 Determination that[35]:

"…the Commission has identified a need for additional facilities at Dublin airport to relieve congestion at Piers A and B…The Commission, by way of maximum levels of airport charges, has provided Aer Rianta with adequate resources to construct such facilities in the short to medium term. The Commission will carefully monitor the Aer Rianta CAPEX programme during the period of the Determination to determine if Aer Rianta is providing additional capacity that meets the requirements of users of the airport."

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[33] Page 76, CP3/2005.

[34] Even in industries where yardsticks are available, such as UK water and electricity distribution, the regulator has still tended to rely on recorded and projected costs of the regulated companies.

[35] See CAR (2001), "Report on the Determination of Maximum Levels of Airport Charges, Part 1", Commission Paper CP8/2001, August, pp.8-9.

and that[36]:

"The Commission…has included in the…Recoverable Capex Programme the funds for the building of a fourth pier at Dublin Airport…[I]t obtained independent justification of the need for an additional pier from its consultants, IMG, and because this project had the general support of airline airport users."

Therefore, contrary to what the Panel appears to believe, projected expenditure in respect of required capacity at Dublin Airport was linked to a specific project. Moreover, the Commission sent a very clear signal that it would be monitoring Aer Rianta's capital expenditure and whether any capacity provided met the needs of users. The implied signal in respect of regulated charges was that the Commission would be minded to adjust them depending on the outcome of that specific project, or any other capacity projects that the company was minded to undertake during the period of the Determination. The decision by the Commission to incorporate a clawback in the 2005 Determination for revenues earned in respect of the fourth pier that was not delivered during the period of the first Determination is, therefore, consistent with the approach that it signalled in 2001.

The Commission rejects the assertion that this policy is inconsistent with an acknowledgement (by the Commission) that things will not go exactly to plan and that flexibility to adjust plans is to be positively encouraged. In fact, the Commission, in reference to its 2005 draft determination stated [37]:

"…the Commission drew the attention of interested parties to the consideration being given to…other adjustments to the RAB, to maintain appropriate incentives for efficient performance by the company. These were…whether adjustments should be made for savings in capital expenditure that were not the result of efficiency but instead as a result of a change in the scope or output of the capital programme."

It went on to say:

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[36] See CAR (2001), "Report on the Determination of Maximum Levels of Airport Charges", Commission Paper CP9/2001, August, p.32, no. 63.

[37] See CAR (2005), "Maximum Levels of Airport Charges at Dublin Airport: Determination", Commission Paper CP3/2005, pp. 70-71.

"The Commission suggested that the adjustment for capital expenditure savings might be desirable in order to prevent a company from being rewarded for savings made by not building the assets that users reasonably required and had been asked to contribute towards (e.g., the income calculated in earlier Determinations that users have paid towards the construction of a Pier D that has not, in fact, been built)."

The Commission's clawback was, therefore, a policy response to precisely the type of change in plan that the Panel discusses.

Claw-backs are not unprecedented in modern economic regulation or, more specifically, modern economic regulation of airports. The UK CAA incorporated in its 2003-08 price cap for Heathrow Airport a claw-back of capital expenditure under spend in the previous period resulting from the delay to Terminal 5 being given planning permission.[38] In endorsing the principle underlying the decision, the UK Competition Commission noted [39]:

"We acknowledge that treatment of past under-investment may be regarded as a guide to the future, and therefore have an effect on incentives, and that a principle of full recovery [by the regulator] of under-investment could result in BAA investing in projects even where it becomes apparent they are not necessary. But, if there is no recovery of under-investment, users effectively pay twice. The circumstances we are considering – of delay to expected expenditure on one major project for which a specific adjustment to charges was made – are, however, exceptional. There is, therefore, no presumption that lower expenditure due to capital efficiency would ever be treated analogously and more general issues of incentives or inferences from the approach we have put forward do not arise.

The circumstances in respect of T5 referred to by the UK Competition Commission are directly analogous to the circumstances in respect of Pier D faced by the Commission. Like the UK Competition Commission, the Commission's position is that the Pier D claw-back does not give rise to a presumption that lower expenditure due to capital efficiency would ever be treated analogously nor does it give rise to inferences about more general

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[38] See CAA (2002), "Heathrow, Gatwick and Stansted Airports: CAA Proposals for Consultation", November.

[39] See Competition Commission (2002), "BAA plc: a report on the economic regulation of the London Airport Companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)", November.

incentive issues. In fact, the Commission has explicitly recognised the appropriateness of retention by the company of efficiency savings that benefit users. In its Draft Determination, it stated [40]:

"It would be appropriate for a company to retain some reward for making efficiencies that benefit users in due course."

Likewise, the Commission is of the view that demonstrable inefficiency that is to the detriment of users should be penalised if it arises from factors within the control of the regulated company. However, the Commission did not, at any point, advance punishment for some notion of "non-compliance" as a reason for the clawback. Rather, the stated reason was to protect the interests of users, who had paid contributions to a facility that was not delivered and who, simultaneously were being asked to make contributions now towards its future delivery.

The Commission also rejects the assertion that it has applied the approach of clawback selectively. Commercial revenues form a fundamentally different element of the price cap. First, they are not within the control of the airport operator, who can invest to attract commercial revenues (such as marketing etc) but may or may not succeed in doing so. Second, it is important not to blunt the incentive for the company to try to maximise these revenues by adjusting the price cap for over-performance in commercial revenues. There would be no incentive to succeed because additional revenues would be immediately expropriated through the regulatory system. Likewise, adjustments for under-performance would blunt the incentive to hit or beat projections because any shortfall would be immediately passed on to the regulated firm.

The Commission has, however, signalled its intention to consider the applicability of a rolling incentive mechanism for commercial revenues.[41] This would serve to guarantee the retention of a pre-determined and agreed proportion of commercial revenue out-performance by the company. Likewise, the company would only have to bear a certain proportion of commercial revenue under-performance before regulated airport charges

[40] See CAR (2005), "Maximum Levels of Airport Charges at Dublin Airport: Draft Determination", CP2/2005, May.

[41] See Annex 15 to CP3/2005, "Suggested Template for 'Rolling Schemes' for inclusion in the future price regulation of Dublin Airport."

were increased to reflect that under-performance. Such a scheme should still preserve the incentive to maximise commercial revenues and to hit and beat projections.

The Commission also rejected the assertion that the clawback signals a negative regulatory attitude to CAPEX to the investment community. Rather, the signal was that if users have been asked to contribute towards, for example, a capacity project like a fourth pier at Dublin Airport, and that project is not delivered, then users would be reimbursed through appropriate reductions in maximum levels of airport charges. This is, in the Commission's view, a robust policy measure that is supported by precedent and that is consistent with the approach that it signalled in 2001.

The Commission rejected the blanket presumption that retrospective adjustments like clawbacks invariably give rise to regulatory uncertainty. Regulatory uncertainty, the Commission would argue, would be more likely to arise if the bases for making such adjustments were inconsistent. As set out above, the decision by the Commission to incorporate a claw-back for revenues earned in respect of the undelivered fourth pier during the period of the first Determination is consistent with the approach that it signalled in 2001. It also provides a very clear signal for future policy, that is, that contributions by users through airport charges towards capacity projects that are not delivered will be reimbursed. Therefore, it cannot be validly claimed that this policy will give rise to regulatory uncertainty.

The Commission does, however, accept the view (expressed by Aer Lingus and echoed by bmi) that it is important that the Commission provides clarity on what is expected to be delivered (and when, albeit that that is more difficult) within the spending limits fixed in the Determination in order to provide certainty to users. This will be important and useful when it comes to assessing capacity projects that are in fact delivered and whose outcome might deliver efficiencies that should be rewarded or demonstrable inefficiency that is to the detriment of users and should be penalised. The Commission proposes to address this issue as part of any subsequent Capex review.

4.3 Forecasted Commercial Revenues

The Panel referred the Commission's forecasts of the DAA's commercial revenues back to the Commission for review. The Panel considered that the Commission had *"consistently ignored or set aside relevant evidence in favour of a simpler, selective and ad hoc approach to assessment."* [42] The Panel considered that the Commission had placed too much weight on the results of benchmarking. The Panel also considered that the failure to include, in the report of the Determination, a discussion of the possible reasons for the Commission's over-estimate (in 2001) of the former Aer Rianta's commercial revenues was *"unlikely to inspire confidence"* [43] that the current projections would be more accurate than in the past.

On specific income streams, the Panel considered that the projections of revenue from property and particularly from car parking had not taken sufficient account of limiting factors such as the timing of rent reviews and physical capacity constraints on car parks.

The Panel contended that the Commission had overemphasised the link between commercial revenues and passenger growth, while the Commission *"systematically ignores other relevant factors and evidence"*. [44]

Finally, the Panel expressed its views in respect of the circumstances in which the Commission could substitute forecasts based on simpler methodologies (which the Panel said was the Commission's approach) for the DAA's forecasts.

Following its publication of the Panel's decision, the Commission sought views from airport users and other interested parties on the three matters that had been referred back to the Commission. Submissions on the commercial revenue forecasts were received from Aer Lingus, the DAA, IBEC, ITIC, and Ryanair.[45]

Ryanair considered that it had no reason to conclude that the Commission's forecasts were flawed.

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[42] Paragraph 6.6.4 of the Appeal Panel's Decision

[43] Paragraph 6.6.4 of the Appeal Panel's Decision

[44] Paragraph 6.6.6 of the Appeal Panel's Decision

[45] The full text of these submissions have been placed on the Commission website www.aviationreg.ie.

Aer Lingus considered that the Commission should take a balanced approach to commercial revenue forecasts, scrutinising the DAA's figures but not setting unrealistically high forecasts that could damage the DAA's ability to invest in airport capacity. Aer Lingus considered that the Commission should therefore reconsider its forecasts. With regard to the previous Determination's estimates, Aer Lingus does not support the retrospective adjustment of commercial revenue figures.

On behalf of the **DAA**, NERA stated that the Commission would not be acting out of line with standard regulatory practice if it accepted the DAA's projections without adjustment, and that this would be the most appropriate course of action for the Commission to take. **IBEC** questioned whether the Commission's forecasts were sufficiently rigorous. **ITIC** recommended that the Commission use the DAA's forecasts subject to a later 'clawback' by the Commission if the company's forecasts proved to be understated.

Following careful consideration of the Panel's decision, and also of the submissions received, the Commission has varied the 2005 Determination by substituting the DAA's forecasts for future property revenues for those used in the 2005 Determination. The Commission has not varied the 2005 Determination in respect of the forecasts of the other commercial revenue streams at Dublin Airport that were used in the 2005 Determination. The Commission's reasons for its decision are as follows.

4.3.1 The Individual Commercial Revenue Streams

On specific income streams, the Panel considered that the projections of revenue in the 2005 Determination from property and particularly from car parking had not taken sufficient account of limiting factors such as the timing of rent reviews and physical capacity constraints on car parks.

Regarding the Panel's views on regulatory policy as it might relate to commercial revenue forecasts, the Commission has already noted that the Panel has no prescribed role beyond making a referral to the Commission, and no role in recommending particular regulatory approaches.

4.3.1.1 Retail revenues

The Commission's assumptions for retail revenues were some 3.4% higher than the DAA's own assumptions. The projections for the current period have been significantly

informed by forecasts prepared by DAA and by the Commission's expert advisers. In its 2005 Determination, the Commission considered it had adequate evidence to support a reasoned expectation that retail revenues would be some 3.4% higher over the period 2006-09 than set out by DAA in its submission to the Commission. This small overall difference is in the context of some underlying volatility in retail revenues per passenger (annual changes of plus or minus 4 or 5% over the past few years) and a recognition that the trends in external benchmarks, albeit only referred to with extreme caution, are consistent with the view expressed by the Commission's consultants that there is some scope for better performance than indicated in DAA's submission.

The Commission has considered the Appeal Panel's comments regarding the use of benchmarking in relation to retail revenues and it is satisfied that its consultants did refer to the results of benchmarking with extreme caution and avoided any specific extrapolation of benchmarks. (See Section 4.3.2 also.)

In its more detailed submission, DAA also identified a number of measurement issues relevant to the interpretation of benchmarks and the use of general inflation indices. The Commission is satisfied that its consultants gave the fullest recognition to the existence of measurement issues, which are generic to all benchmarking exercises and can significantly distort comparisons both ways. They placed little reliance, and no substantive reliance, on DAA's position in the benchmark 'league tables', but used the data together with its wider knowledge and experience of airport retail businesses, on trends in particular, to inform its more general assessments about future retail revenues.

The Commission considers that the Panel comments on retail revenues do not provide a substantive basis to vary the 2005 Determination.

4.3.1.2 Car park revenues

The Appeal Panel highlights physical constraints in car parking infrastructure at the airport as a constraint on the DAA's car parking revenue-earning potential. This is reflected in the DAA's projections in a substantially flat pattern of car parking revenues through to 2009, in the context of a continuing trend of rapid growth in airport activity.

The projection of car park revenues relates to the question of demand for car parking at the airport, but there are two dimensions to demand – volume and price. With limited

physical capacity for car parking, an underlying pattern of increasing demand would lead to additional costs for users. One would expect those costs to be reflected either in increased parking charges, increased congestion or the use of second-choice alternatives to travelling by car to the airport. The number of parking events per passenger would have to fall and a continued fall in the pattern of 'meeters and greeters' may be part of this trend.

Both the Commission's consultants and the DAA projected reductions in revenues per passenger. However, the Commission's consultants projected some increases in total revenues. In practice, this would be expected to arise through a combination of increased utilisation of existing car parking capacity and increases in car parking charges – increases that would be necessary to avoid an underlying pattern of increasing demand to translate into increased congestion. The Commission's consultants referrred to the levels of car parking charges at other airports to inform its view that its revenue projections would be consistent with relatively modest rises in car parking charges.

The Commission considers that the Panel comments on car park revenues do not provide a substantive basis to vary the Determination.

4.3.1.3 Property revenues

The Panel comments on property revenues suggested that the Commission's projections were linked to passenger numbers. Although the mechanism for calculating projections used a passenger-based formula and some components of property revenue will be correlated with passenger numbers (for example concession fees from car hire operators), the rate of increase was instead informed by a wider assessment of the scope for increases in property income. As the DAA submitted and the Appeal Panel noted, only a proportion of the DAA's total stock of rental properties will have rent reviews during the period. One might expect that, due to the longer review periods, the rent increases arising from those subject to rent reviews might be expected broadly to compensate for the proportion without rent reviews.

The Commission has carefully re-examined its assumptions in regard to future property revenues at Dublin Airport. The Commission considers that it can no longer safely assume the increases in property income that it assumed for the 2005 Determination. It has therefore concluded that it should vary the Determination of airport charges to reflect in full DAA's projections for property income.

4.3.2 The Commission's Approach to Forecasting Commercial Revenues

Concerning whether the Commission's approach placed too much weight on the results of benchmarking, the Commission wishes to clarify that its commercial revenue forecast did not in fact do so, nor did it involve the selective substitution of poorer for better information. The 2001-2005 commercial revenue outturn was not discussed in the Commission's 2005 Determination because many earlier Commission reports (available on the Commission's website) had set out the reasons for that outcome.

The basis of the commercial revenue work for the Commission by Alan Stratford and Associates (ASA) in conjunction with Airport Retail Consultants (ARC) was as follows. First, ASA/ARC formed an overall qualitative judgement of the commercial revenue prospects at Dublin Airport with reference to a number of widely cited authoritative international benchmarks in this area. Second, after this contextualisation, ASA/ARC took the DAA's figures for the 2004 commercial revenue outturns at Dublin Airport and used them as a basis for forecasting future commercial revenues. ASA/ARC also held a number of detailed discussions with relevant staff of the DAA, which allowed ASA/ARC to make specific adjustments for factors particular to that business. The ASA/ARC estimates also incorporated the professional and business judgement of ASA/ARC including their experience with other airport businesses. Third, the ASA/ARC initial revenue estimates were provided in May 2005 to the DAA that led to further detailed engagement by ASA with the DAA. Following this and also careful consideration of the statutory representations received by the Commission following the draft Determination of May 2005, ASA/ARC reviewed their forecasts and decided to revise them downwards. The Commission then adopted the revised ASA/ARC forecasts for its 2005 price Determination.

Thus, benchmarks were only one piece of information amongst many used in the making of the ASA/ARC forecasts, and the multi-ingredient and multi-stage process cannot validly be described as quantitative benchmarking. For the same reason, the *"common ground"* identified by the Panel in the DAA's submission in this area, whereby the Commission is said to have *"consistently ignored or set aside relevant evidence in favour of a simpler, selective and ad hoc approach to [commercial revenue] assessment"* is an inaccurate characterisation of the ASA/ARC methodology.

As the complete ASA/ARC report (which the CAR did not publish on grounds of DAA commercial confidentiality) and the associated tables were provided to the DAA,

inspection of these would immediately reveal that the ASA/ARC estimate of commercial revenues differed from the DAA's by a few percentage points whereas, for example, the TRL table shows a 51.4% difference. From this contrast, it is quite obvious that the ASA/ARC forecasts could not have been based on quantitative benchmarks.

Given the mis-characterisation of the Commission's approach, it follows that any inferences that rely on such foundations are likewise considered to be unsound. In particular, allegations of bias that derive from a mistaken characterisation of the Commission's work necessarily fall.

The Panel also expressed a lack of confidence in the Commission's commercial revenue forecasts on the grounds of there being no discussion in the 2005 Determination of the possible reasons for the over-projection in 2001 of the former Aer Rianta's commercial revenues.

This is somewhat of a surprising statement. Due to the considerable discussion of the reasons for, and the outcome of, the Commission's 2001 commercial revenue forecasts in many prior Commission papers [46] and furthermore the highly detailed engagement on this issue in the Judicial Review action taken by the former Aer Rianta against the Commission, the Commission considered that there was no added value in repetition and omitted this topic from the Report on the 2005 Determination, especially given the number of other, pressing and current, matters that needed to be explained.

However in order to correct the impression created by the Panel's interpretation, the Commission has decided to summarise here the key facts in this area. Although the Commission's 2001-2005 forecasts of the DAA's commercial revenues did indeed differ by the large amount of €90m from the revenues achieved by the company, there is no reason for this to undermine confidence in the latest forecasts prepared by ASA/ARC for the Commission. This is especially so because the decisive constraint on the 2001 commercial revenue forecast – the withholding of relevant information by the regulated firm – was lifted by the DAA in 2005.

In 2001, the Commission wished to prepare projections of future commercial revenues for Dublin Airport. To this end, it needed the commercial revenue outturn data for a

[46] Including August 2001 Determination (CP7/2001), the 2002 Varied Determination (CP2/2002) and most fully in the 2004 Mid-Term Review Determination (CP4/2002).

recent base year, traffic values to allow commercial revenue to be expressed in per-passenger terms, a medium term traffic forecast, and good information from the company regarding specific factors with a material bearing on commercial revenue prospects. The Commission is empowered by virtue of Section 32 (13) of the 2001 Act, to seek and secure the information necessary for the making of a Determination. The 2001 Act provides that *"For the purposes of this section, the Commission may request an airport authority in writing to provide information (including accounts, estimates, returns, projections or any other records) to it which is in the possession of or which can be obtained by the airport authority"*.

Except for the traffic forecast, the former Aer Rianta did not provide certain required information to the Commission. Even with good information, forecasts can still be wrong. Forecasts that are made where available good information is withheld from the forecaster are certain to be inferior. Faced with the absence of the required information, the Commission commenced an action in the High Court to compel the former Aer Rianta to hand over the information [47] sought by the Commission as provided for under the Aviation Regulation Act, 2001. A settlement was reached with the company according to which a large body of information was provided to the Commission.[48] However, much of this information was not in a form that could be readily analysed [49], and required to be reconstituted from the former Aer Rianta's (electronic) general ledger. Per-passenger amounts, along with the company's passenger traffic forecast, were used to estimate future commercial revenues on an assumed, but reasonable, one-for-one basis. [50]

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[47] The full set of information requested from the company was large and extended well beyond the area of commercial revenues.

[48] In its formal submissions to the Commission, the former Aer Rianta did provide in confidence a forecast of net earnings (before interest and taxation) from commercial revenues. But as no explanation of the basis for these numbers was provided, the Commission was unable to rely upon them.

[49] In particular, analysis and understanding of the general ledger was greatly hampered by the number of abrupt, unexplained and seemingly arbitrary changes of classification. To improve its understanding of these matters, the Commission sent the company a list of 160 questions seeking to clarify the ledger entries. The high-level response from the company did not substantively address the Commission's queries.

[50] Importantly, the company's estimated future operating costs were forecast using the same methodology. Since airports are often considered to experience scale economies so that costs rise less rapidly than passenger traffic (a view supported in 2001 by the company's own internal budgetary documentation) this forecasting methodology for net opex (opex less commercial revenues) was more

In the event, this forecast overestimated the company's commercial revenues. In part this was due to the relatively simple forecasting exercise forced on the Commission by the company's policies. In addition, the terrorist attacks of September 11 2001 were associated with a traffic outturn below the company's traffic forecast that was also used in the projecting of commercial revenues.

In the context of a review of the price cap undertaken by the Commission in 2004, the DAA asked that the basis of the commercial revenue forecast be reconsidered. The Commission declined to do so. The Commission's general thinking is set out in Section 4 of the report on the Determination that resulted from that review (CP4/2004). The treatment of commercial revenues is considered in section 4.5.2 and at greater length in section 6.5 of that report. [51]

In conclusion, the Commission has at all times made clear the basis of its commercial revenue forecasts which was the only basis on which forecasts could have been made in 2001 faced with a high level of non-cooperation by the company. The extent of previous discussions of the matter led the Commission to think that further rehearsal of the issue was not required in the 2005 Determination.

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advantageous to the company than would have been an approach in which revenues (but not costs) were projected in line with passenger traffic.

[51] The Commission declined to adjust its commercial revenue forecast to align them with the company's outturn revenues on the basis of the impairment of incentives that would result for the company. The Commission argued that retrospective changes of this kind would in effect convert a regime of incentive regulation into cost-plus regulation. The Commission made an explicit exception to this principle in respect of "projects deemed necessary for users at the time of the original but which have been abandoned or delayed" (CP4/2004, p.46) clearly pointing to its 2005 decision on 'clawing back' the income earned by the DAA on a Pier D that was not built.

ANNEX I: VARIED DETERMINATION

This section sets out the Determination as varied. This varied Determination replaces the 2005 Determination as set out in Commission Paper, CP3/2005.

Regulatory Period 1 January to 31 December 2006

1. The airport authority shall ensure that, for the regulatory period 1 January to 31 December 2006, the average revenue per passenger yielded by way of airport charges levied at Dublin Airport shall not exceed:

   $$Y_{06}^{Dub} = €6.20$$

   where

   Y_{06}^{Dub} is the maximum average revenue per passenger using Dublin Airport in the regulatory period 1 January to 31 December 2006.

2. In the regulatory period 1 January to 31 December 2006, the airport authority shall not levy an airport charge in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport that exceeds:

   $$C_{06}^{Dub} = C_{05}^{Dub}\left(1 + \frac{\Delta CPI_{05} - X_{06}^{Dub}}{100}\right)$$

   where

   C_{06}^{Dub} is the maximum charge per tonne that can be levied in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport during the regulatory period 1 January to 31 December 2006.

   $C_{05}^{Dub} = €13.42$ is the maximum charge per tonne that can be levied in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport during the regulatory period 1 January to 31 December 2005, as set out in the Commission’s 2004 Annual Compliance Statement, CP10/2004.

ΔCPI_{05} is the percentage change (whether of a positive or negative value) in the Consumer Price Index between that published in October 2004 and October 2005.

$X_{06}^{Dub} = 3.7$

The setting of this maximum charge does not constitute approval of charges in respect of cargo handling under the European Communities (Access to the Ground handling Market at Community Airports) Regulations, 1998 (S.I. No. 505 of 1998).

Regulatory Period 1 January to 31 December 2007

1. The airport authority shall ensure that, for the regulatory period 1 January to 31 December 2007, the average revenue per passenger yielded by way of airport charges levied at Dublin Airport shall not exceed:

$$Y_{07}^{Dub} = YU_{07}^{Dub} + W_{05}^{Dub} + K_{05}^{Dub}$$

where

Y_{07}^{Dub} is the maximum average revenue per passenger using Dublin Airport in the regulatory period 1 January to 31 December 2007;

$$YU_{07}^{Dub} = Y_{06}^{Dub}\left(1 + \frac{\Delta CPI_{06} - X_{07}^{Dub}}{100}\right)$$

ΔCPI_{06} is the percentage change (whether of a positive or negative value) in the Consumer Price Index between that published in October 2005 and October 2006.

$X_{07}^{Dub} = -4$

W_{05}^{Dub} is the difference, with interest, between the Commission's estimate for its 2004 Annual Compliance Statement of its actual 2004 costs and expenses, and its final audited 2004 costs and expenses, plus the difference, during the period 1 January 2005 to 31 December 2005, between the Commission's actual costs and expenses and budgeted costs and expenses that are recoverable through airport charges levied at Dublin Airport, which is derived from the following formula:

$$W_{05}^{Dub} = (E_{05}^{Dub*} - E_{05}^{Dub})\frac{1}{T_{07f}^{Dub}}(1 + \frac{I_{05}}{100})(1 + \frac{I_{06}}{100})$$

in which

E_{05}^{Dub*} is the Commission's actual cost and expenses in the period 1 January to 31 December 2005, that are recoverable through airport charges levied at Dublin Airport;

E_{05}^{Dub} is the Commission's budgeted costs and expenses, in the period 1 January to 31 December 2005, that are recoverable through airport charges levied at Dublin Airport;

T_{07f}^{Dub} is the number of passengers forecast to use Dublin Airport during the period 1 January to 31 December 2007;

I_{05} is the average of the rate (expressed as an annual percentage interest rate) on three-month commercial paper issued between December 2004 and November 2005 by the National Treasury Management Agency (NTMA).

I_{06} is the average of the rate (expressed as an annual percentage interest rate) on three-month commercial paper issued between December 2005 and November 2006 by the National Treasury Management Agency (NTMA).

K_{05}^{Dub} is the correction per passenger to be made in the regulatory year 1 January to 31 December 2007, which is derived from the following formula:

$$K_{05}^{Dub} = \left(Y_{05}^{Dub} - Y_{05}^{*Dub}\right)\left(\frac{T_{05}^{Dub}}{T_{07f}^{Dub}}\right)\left(1 + \frac{I_{05}}{100}\right)\left(1 + \frac{I_{06}}{100}\right)$$

in which

$Y_{05}^{Dub} = €4.90$ is the maximum average revenue per passenger using Dublin Airport in the regulatory period 1 January to 31 December 2005, as set out in the Commission's 2004 Annual Compliance Statement;

Y_{05}^{*Dub} is the actual average revenue per passenger from airport charges levied at Dublin Airport in the regulatory period 1 January to 31 December 2005;

T_{05}^{Dub} is the number of passengers using Dublin Airport during the period 1 January to 31 December 2005.

2. In the regulatory period 1 January to 31 December 2007, the airport authority shall not levy an airport charge in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport that exceeds:

$$C_{07}^{Dub} = C_{06}^{Dub}\left(1 + \frac{\Delta CPI_{06} - X_{07}^{Dub}}{100}\right)$$

where

C_{07}^{Dub} is the maximum charge per tonne that can be levied in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport during the regulatory period 1 January to 31 December 2007.

The setting of this maximum charge does not constitute approval of charges in respect of cargo handling under the European Communities (Access to the Groundhandling Market at Community Airports) Regulations, 1998 (S.I. No. 505 of 1998).

Regulatory Period 1 January to 31 December 2008

1. The airport authority shall ensure that, for the regulatory period 1 January to 31 December 2008, the average revenue per passenger yielded by way of airport charges levied at Dublin Airport shall not exceed:

$$Y_{08}^{Dub} = YU_{08}^{Dub} + W_{06}^{Dub} + K_{06}^{Dub}$$

where

Y_{08}^{Dub} is the maximum average revenue per passenger using Dublin Airport in the regulatory period 1 January to 31 December 2008;

$$YU_{08}^{Dub} = YU_{07}^{Dub}\left(1 + \frac{\Delta CPI_{07} - X_{08}^{Dub}}{100}\right)$$

ΔCPI_{07} is the percentage change (whether of a positive or negative value) in the Consumer Price Index between that published in October 2006 and October 2007.

$X_{08}^{Dub} = -4$

W_{06}^{Dub} is the difference, during the period 1 January 2006 to 31 December 2006, between the Commission's actual costs and expenses and budgeted costs and expenses that are recoverable through airport charges levied at Dublin Airport, which is derived from the following formula:

$$W_{06}^{Dub} = (E_{06}^{Dub*} - E_{06}^{Dub})\frac{1}{T_{08f}^{Dub}}(1 + \frac{I_{06}}{100})(1 + \frac{I_{07}}{100})$$

in which

E_{06}^{Dub*} is the Commission's actual cost and expenses in the period 1 January to 31 December 2006, that are recoverable through airport charges levied at Dublin Airport;

E_{06}^{Dub} is the Commission's budgeted costs and expenses, in the period 1 January to 31 December 2006, that are recoverable through airport charges levied at Dublin Airport;

T_{08f}^{Dub} is the number of passengers forecast to use Dublin Airport during the period 1 January to 31 December 2008;

I_{06} is the average of the rate (expressed as an annual percentage interest rate) on three-month commercial paper issued between December 2005 and November 2006 by the National Treasury Management Agency (NTMA).

I_{07} is the average of the rate (expressed as an annual percentage interest rate) on three-month commercial paper issued between December 2006 and November 2007 by the National Treasury Management Agency (NTMA).

K_{06}^{Dub} is the correction per passenger to be made in the regulatory year 1 January to 31 December 2008, which is derived from the following formula:

$$K_{06}^{Dub} = \left(Y_{06}^{Dub} - Y_{06}^{*Dub}\right)\left(\frac{T_{06}^{Dub}}{T_{08f}^{Dub}}\right)(1+\frac{I_{06}}{100})(1+\frac{I_{07}}{100})$$

in which

Y_{06}^{*Dub} is the actual average revenue per passenger from airport charges levied at Dublin Airport in the regulatory period 1 January to 31 December 2006;

T_{06}^{Dub} is the number of passengers using Dublin Airport during the period 1 January to 31 December 2006.

2. In the regulatory period 1 January to 31 December 2008, the airport authority shall not levy an airport charge in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport that exceeds:

$$C_{08}^{Dub} = C_{07}^{Dub}\left(1+\frac{\Delta CPI_{07} - X_{08}^{Dub}}{100}\right)$$

where

C_{08}^{Dub} is the maximum charge per tonne that can be levied in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport during the regulatory period 1 January to 31 December 2008.

The setting of this maximum charge does not constitute approval of charges in respect of cargo handling under the European Communities (Access to the Groundhandling Market at Community Airports) Regulations, 1998 (S.I. No. 505 of 1998).

Regulatory Period 1 January to 31 December 2009

1. The airport authority shall ensure that, for the regulatory period 1 January to 31 December 2009, the average revenue per passenger yielded by way of airport charges levied at Dublin Airport shall not exceed:

$$Y_{09}^{Dub} = YU_{09}^{Dub} + W_{07}^{Dub} + K_{07}^{Dub}$$

where

Y_{09}^{Dub} is the maximum average revenue per passenger using Dublin Airport in the regulatory period 1 January to 31 December 2009;

$$YU_{09}^{Dub} = YU_{08}^{Dub}\left(1 + \frac{\Delta CPI_{08} - X_{09}^{Dub}}{100}\right)$$

ΔCPI_{08} is the percentage change (whether of a positive or negative value) in the Consumer Price Index between that published in October 2007 and October 2008.

$X_{09}^{Dub} = -4$

W_{07}^{Dub} is the difference, during the period 1 January 2007 to 31 December 2007, between the Commission's actual costs and expenses and budgeted costs and expenses that are recoverable through airport charges levied at Dublin Airport, which is derived from the following formula:

$$W_{07}^{Dub} = (E_{07}^{Dub*} - E_{07}^{Dub})\frac{1}{T_{09f}^{Dub}}(1 + \frac{I_{07}}{100})(1 + \frac{I_{08}}{100})$$

in which

E_{07}^{Dub*} is the Commission's actual cost and expenses in the period 1 January to 31 December 2007, that are recoverable through airport charges levied at Dublin Airport;

E_{07}^{Dub} is the Commission's budgeted costs and expenses, in the period 1 January to 31 December 2007, that are recoverable through airport charges levied at Dublin Airport;

T_{09f}^{Dub} is the number of passengers forecast to use Dublin Airport during the period 1 January to 31 December 2009;

I_{07} is the average of the rate (expressed as an annual percentage interest rate) on three-month commercial paper issued between December 2006 and November 2007 by the National Treasury Management Agency (NTMA).

I_{08} is the average of the rate (expressed as an annual percentage interest rate) on three-month commercial paper issued between December 2007 and November 2008 by the National Treasury Management Agency (NTMA).

K_{07}^{Dub} is the correction per passenger to be made in the regulatory year 1 January to 31 December 2009, which is derived from the following formula:

$$K_{07}^{Dub} = \left(Y_{07}^{Dub} - Y_{07}^{*Dub}\right)\left(\frac{T_{07}^{Dub}}{T_{09f}^{Dub}}\right)(1 + \frac{I_{07}}{100})(1 + \frac{I_{08}}{100})$$

in which

Y_{07}^{*Dub} is the actual average revenue per passenger from airport charges levied at Dublin Airport in the regulatory period 1 January to 31 December 2007;

T_{07}^{Dub} is the number of passengers using Dublin Airport during the period 1 January to 31 December 2007.

2. In the regulatory period 1 January to 31 December 2009, the airport authority shall not levy an airport charge in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport that exceeds:

$$C_{09}^{Dub} = C_{08}^{Dub}\left(1 + \frac{\Delta CPI_{08} - X_{09}^{Dub}}{100}\right)$$

where

C_{09}^{Dub} is the maximum charge per tonne that can be levied in respect of services supplied in connection with the transportation by air of cargo to or from Dublin Airport during the regulatory period 1 January to 31 December 2009.

The setting of this maximum charge does not constitute approval of charges in respect of cargo handling under the European Communities (Access to the Groundhandling Market at Community Airports) Regulations, 1998 (S.I. No. 505 of 1998).

ANNEX II: YIELD TABLE AND EXPLANATORY NOTE

Passenger forecasts	2006	2007	2008	2009
	mpax	*mpax*	*mpax*	*mpax*
Non-EU embarking	1.2	1.4	1.5	1.7
EU embarking	8.6	9.0	9.4	9.7
Total emb. & disemb.	19.6	20.7	21.8	22.9
Discount factors	1.036	1.112	1.195	1.283

Required revenue calculation		2006	2007	2008	2009	PV
CPIye2004 - 109.8		*€m*	*€m*	*€m*	*€m*	*€m*
RAB at the start of the year		615.7	693.9	808.4	855.0	(615.7)
Net investment		121.9	160.8	95.0	98.3	(418.4)
Depreciation		(43.7)	(46.3)	(48.4)	(49.0)	
RAB at the end of the year		693.9	808.4	855.0	904.3	679.7
Average RAB		654.8	751.1	831.7	879.7	
Discounting rate of return		7.40%	7.40%	7.40%	7.40%	
Rate of return on average RAB		7.14%	7.14%	7.14%	7.14%	
Allowed return		46.7	53.6	59.4	62.8	
Operating expenditure		149.6	156.3	161.5	165.4	(549.0)
Net commercial revenues		(120.2)	(123.5)	(129.6)	(137.7)	442.9
Regulatory levy		2.0	1.7	1.7	2.2	(6.6)
Depreciation		43.7	46.3	48.4	49.0	
Other adjustments						
Allowed revenues, before profiling		121.8	134.4	141.3	141.8	467.2
						0.0
Allowed revenues per passenger, before profiling		€6.22	€6.48	€6.49	€6.18	
Annual X in CPI-X (-ve = increase)		N/A	-4.00%	-4.00%	-4.00%	
Anticipated lagged October to October CPI			2.40%	2.50%	2.50%	
Anticipated average to average CPI			2.45%	2.50%	2.50%	
Revenues per passenger, profiled	€4.82	€5.99	€6.22	€6.46	€6.72	
(1 + CPI - X)						
Allowed revenues, after profiling		117.3	129.0	140.8	154.1	467.2
Allowed revenues, after forecast inflation		€6.20	€6.60	€7.03	€7.48	

High Level Statistics	
CPIye2004 - 109.8	*CP2*
PV revenues in CP2	**€467.2m**
Average price in period	**€6.34**
Average FFO: debt	**15.4%**

RAB at 1 January 2006	
CPIye2004 - 109.8	*€m*
Opening RAB per determination	601.2
Pier C adjustment	13.4
Increased capex projected for 2005	1.2
Opening RAB	615.7

Net investment	2005	2006	2007	2008	2009
CPIye2004 - 109.8	*€m*	*€m*	*€m*	*€m*	*€m*
Net investment per determination		112.7	156.1	95.0	98.3
Increased allowance for Pier D	1.2	9.2	4.7		
Net investment per variation		121.9	160.8	95.0	98.3

Allowed depreciation	2006	2007	2008	2009
CPIye2004 - 109.8	*€m*	*€m*	*€m*	*€m*
Allowed depreciation per determination	43.6	45.9	47.9	48.6
Depreciation effect of capex differences	0.2	0.4	0.4	0.4
Allowed depreciation	43.7	46.3	48.4	49.0

Commercial revenues	2006	2007	2008	2009
CPIye2004 - 109.8	*€m*	*€m*	*€m*	*€m*
Commercial revenues per determination	120.4	126.1	132.8	141.3
Lower property revenues	(0.2)	(2.6)	(3.2)	(3.6)
Commercial revenues	120.2	123.5	129.6	137.7

EXPLANATORY NOTE

Maximum Airport Charges at Dublin Airport

The Determination is expressed in terms of the maximum average revenue per-passenger yielded by way of airport charges at Dublin Airport.

For comparability with the Commission's 2005 Determination, the price base of all figures quoted in the report accompanying the Varied Determination is in December 2004 terms. However, the price cap in the 2005 Determination for regulatory year 2006 was restated in June 2006 prices on the basis of inflation forecasts derived from those in

the summer 2005 ESRI Quarterly Economic Commentary. The same basis is used in this Decision.

The Commission's calculation of the maximum average revenue yield per passenger is shown in the above Table.

As may be seen, the yield is computed through the following calculations:

1. The average (opening plus closing values divided by two) Regulatory Asset Base (RAB) of the airport.
2. *Multiplied by* the accounting rate of return that corresponds with the allowed Pre-tax Weighted Average Cost of Capital (WACC);
3. *Plus* indexed depreciation;
4. *Plus* the projected operating costs (opex);
5. *Minus* projected commercial revenues;
6. With the result *divided by* forecasted passenger numbers;
7. To produce the maximum average revenue yield.

Definitions

For the purposes of the Explanatory Memorandum, the following definitions apply.

"**RAB**" means the regulatory asset base; this is the value on which Dublin Airport Authority is allowed to earn a return. The RAB is calculated through the following steps:

The Indexed Historical Net Book Value of the DAA's Fixed Asset Register as at 31 December 2000
Plus Actual Capex from 1 January 2001 to 31 December 2004
Plus an estimate of Capex for 2005 (adjusted for a different assumption for expenditure on the construction of Pier D)
Minus the proceeds of disposals as per the regulatory accounts
Minus regulatory depreciation allowed in the price cap for the first control period 2001 – 2005
Minus the clawback of revenue received by the DAA during the first control period for the Pier D that was not built.

All amounts are calculated with reference to December 2004 prices.

The Commission has described in greater detail its method for rolling forward the RAB in Section 5.3 of the Commission Paper CP3/2005, the 2005 Determination.

"**WACC**" means the weighted average cost of capital; this is computed as the weighted average of Dublin Airport Authority's cost of equity and its cost of debt, with the weights given by the shares of equity and debt in Dublin Airport Authority's total financing.

"**allowed return**" means the accounting rate of return allowed by the Commission to the airport operator, computed with reference to the weighted average cost of capital multiplied by the average value of the regulatory asset base.

"**depreciation**" means indexed depreciation evaluated with reference to the actual and projected assets recorded in the fixed asset registers of Dublin Airport Authority, using the actual asset lives on an asset-by-asset basis.

"**operating expenditure**," means operating costs, both aeronautical and commercial; the latter would include payroll and non-payroll costs in respect of aeronautical and commercial operations at Dublin Airport.

"**net commercial revenues**" means all revenues from commercial activities (e.g. catering, retailing and car parking) at Dublin Airport minus the cost of goods sold.

"**allowed revenues**" means the total annual revenue, which Dublin Airport Authority is allowed to collect in the form of airport charges.

"**passengers**" means the passenger forecast that the Commission has decided upon for the purposes of the Determination. A passenger is counted each time a person embarks or disembarks from an aircraft at Dublin Airport. The passenger forecast used is set out at Annex 1 of this report.

"**allowed revenues per passenger**" means maximum allowable revenue divided by the passenger forecast.