Third Interim Review of the 2019 Determination at DUB airport

IATA response to CAR's Methodological Consultation and Issues Paper

This submission presents the response of the International Air Transport Association (IATA). IATA's mission is to represent, lead and serve the airline industry and brings together some 290 airlines or 83% of the global air traffic.

IATA welcomes the opportunity to provide comments to the Commission for Aviation Regulation on the Issues Paper of the Third Interim Review of the 2019 Determination of the maximum level of airport charges at Dublin Airport.

Please find below our responses to the questions raised by the CAR in the paper.

Approach to Regulation

<u>Approach to previous years:</u> We are highly concerned about a loss recovery adjustment. CAR has already made a series of adjustments in the benefit of DUB (which it quantified as more than EUR 225 m). Making further allowances would shield the company of risks it was remunerated to bear.

<u>Length of the period</u>: Four years appears to be reasonable, as a means of balancing any upwards pressure on charges from a potentially lower traffic forecast in 2023.

<u>Dealing with extreme downsides:</u> We agree with the CAR's proposal not to include automatic adjustments. Interventions need to be seen "in the round".

<u>Allocation of risk:</u> Firstly, we have already seen that the CAR is willing to intervene in cases of extreme variances in traffic. Secondly, we have also seen that pre-COVID periods showed large variations (vis a vis the forecast traffic) and the CAR did not see any merit in changing the traffic risk of Dublin airport (as being the best placed to deal with such changes). Finally, we see that the industry is already on a recovery path. When taking all of this into consideration, we are not yet convinced on the need to implement any risk sharing mechanism.

In any case, if the CAR sees the need to implement a risk sharing mechanism, it is of paramount importance that this would be in the benefit of consumers (compared to the counterfactual). In this regard, a starting point would need to be how a reduction in risk borne by Dublin airport would be materialized in a reduction of the

WACC. We note that while the Issues paper discusses different risk sharing mechanisms, it does not address their potential effects on the WACC in a similar level of detail.

With respect to the different sharing mechanisms, we have some initial comments:

- TRS: Further discussions on the specific mechanisms (bands, percentage sharing, etc.) are needed. While we understand analyzing the effects of traffic on operating costs when designing a TRS scheme, it is more problematic to consider the effect on non-aeronautical revenues given its compounding effect as well as the reduced incentives on the company to manage deviations. As mentioned previously, there is a need to understand how much WACC would be reduced under different TRS versions.

  In terms of timing, we agree that "in year" adjustments are not desirable due to their complexity and procyclical impact. We would appreciate having further discussions with the CAR on this matter, as it may also be useful to evaluate different timescales for over or under recoveries.

- GRS: A sharing based on EBITDA would significantly reduce the incentives on the regulated company to outperform. We consider this type of risk sharing highly problematic and not beneficial for consumers.

- Capex adjustment mechanism: This mechanism appears to be complicated and would be most effective in circumstances where there are extreme variances in traffic, not smaller ones. Since the CAR has already been willing to intervene in cases of extreme variances in traffic, we are not convinced this would be an appropriate sharing mechanism.

We also note that, unlike previous determinations, the CAR is considering an explicit ex-ante commitment to reopen the determination in case of extreme deviations. Such commitment should be reflected in a lower allowed WACC.

<u>Tradeoffs and interactions across the building blocks</u>:

We understand the interactions among each of the building blocks and therefore see the need to substantially reduce the WACC should the CAR decided on implementing mechanisms that reduce the risk borne by the airport.

We also note the CAR's comment that DUB net debt is 1.1bn and that that may force the regulator to use a financial viability adjustment or a more conservative approach on ratios. Before even considering these adjustments, the CAR also needs to consider whether shareholders have taken the steps expected from them from such crisis (i.e. equity injection). Users should not be expected to bail out the company if shareholders have not done enough to reduce its gearing.

Passenger Forecasts

We note the CAR's comment on the need for transparency when receiving forecasts. IATA would be pleased to share and explain our latest forecasts (& forecast methodology) with CAR at the appropriate time.

Operating Expenditure

<u>Possible approaches for setting allowances</u>: Consistent with our previous submissions, we believe that a bottom-up approach would be the most appropriate way for ascertaining the efficiency gap. Such an approach

proved invaluable in the 2019 determination (and previous ones), so we recommend the CAR to continue it. It is of paramount importance to determine a baseline considering how an efficient company would have reacted to COVID 19 and then establish future allowances from that baseline.

We also see that a top-down analysis could be a useful tool to inform efficiency, but unfortunately, there is not sufficient and consistent airport financial (and service quality) information to carry out a robust cost benchmark. Therefore, we have proposed that the Thessaloniki Forum consider developing a process of consistent airport data gathering, but this has not happened yet.

We see that the CAR utilized a glidepath during the 2019 determination. However, we are currently not that convinced whether the airport should benefit from the use of such a glidepath again. In a normal competitive environment, a company would not have such "time shielding" to make necessary efficiency adjustments to adapt to the current market circumstances to remain competitive.

Operating Costs pass through: An opex pass-through mechanism will inevitably incentive a regulated company to include as many costs as possible through that mechanism and reduce any incentive to try to manage it. It needs to be kept to a minimum.

Remuneration scheme: We are concerned that making an allowance for a VSS scheme could imply the implementation of a loss recovery mechanism through the backdoor. If the CAR intends to consider any allowances, these should be subject to a strict efficiency assessment.

Commercial Revenues

Forecast Methodology: As mentioned on previous occasions, it may be prudent to complement the econometric approach with some bottom-up assessment. Relying solely on an econometric approach implies that the elasticities are based on DAA's own past performance (and therefore the underlying assumption is that the airport is efficient in the generation of commercial revenues).

New lines of commercial revenues AND aero vs. non aero activities: We would like to make to following comments for the CAR's consideration:

- Set down charges: Careful consideration is needed on the potential introduction of set-down charges. While the income would be used to lower aeronautical charges (through the single till) there would be an inherent cost on managing the scheme (and therefore this would constitute an increase in the overall costs paid by consumers). It would therefore be important to assess whether the benefits of the scheme outweigh its costs.

  The additional concern is also linked to the evolution of such charges throughout the regulatory period, as DUB will be incentivized to increase such charge to maximize the income from such activity (which would not be reflected through aero charges if this is done within period).

  The above merits a more detailed discussion as to if and how to implement such set down charges.

- US Preclearance: As highlighted in previous submissions, we believe that there needs to be a cost-based approach for setting US Preclearance charges, rather than treat it as a purely non-aeronautical expense (for which revenues can be fully maximized).

Rolling incentives: As mentioned in previous submissions, we do not see any benefit from introducing rolling incentives (due to modelling vs. real outperformance concerns). This matter is now particularly more acute given the large variations in non-revenue/pax figures over the past years.

Cost of Capital

WACC parameters review: We note that the CAR has hired Swiss Economics to review the WACC parameters to be applicable for the next four years. Like in the 2019 determination process, we would appreciate the opportunity to engage with this consultancy to provide our comments on each of the parameters. In any case, we would also like to share the following initial insights:

- The COVID crisis has demonstrated the extent to which CAR is willing to protect DUB airport. It has applied continuous interim reviews, eliminated the capex clawback mechanism and is now carrying out a full review (which is almost equivalent to shortening the current regulatory period), among other adjustments. This should be reflected in a lower WACC.

- If the CAR implements a risk sharing mechanism it would imply a significant reduction in the risks borne by the regulated company. Therefore, there should be a significant reduction in the allowed beta compared to a beta with no traffic sharing mechanism. To show such an effect, it is imperative that both betas (with and without sharing) are calculated and published. It would also be prudent to show how the beta would move under different risk sharing scenarios. It is our view that the more traffic risk is removed from Dublin airport, the closer the beta should be to that of regulated utilities.

Aiming up: We were not supportive of an aiming up adjustment during the 2019 Determination and continue with that position. Aiming up would constitute an artificial way of increasing charges at the expense of consumers.

Capital expenditure

IATA welcomes the upcoming Capex consultation process for Dublin Airport. This process should lead to better decision making and help ensure that infrastructure plans are properly timed and meet current and future user needs. The IFS assessment of new and updated projects as well as the continuation of the StageGate process is an approach that should be continued into the new determination period.

Triggered Projects**:** With regards to triggered projects, demand triggers should be considered if the type of project warrants it and the trigger can be adequately defined. IATA has been in favor of profiling triggers to ensure timely delivery.

Construction Price Inflation **:** The issue of construction price inflation is one that will be particularly important for this upcoming CIP period. The measure that offers the best chance of accurately reflecting the costs that Dublin Airport will bear and avoids double counting is the one that should be adopted.

Depreciation: We remain supportive of the usage of annuities as that would represent a better spread of the cost of an asset over time. As previously mentioned, the CAR may also wish to consider the utilization of unit-based annuities (i.e., same cost per pax over time) for assets that would have a large unutilized capacity when commissioned, as this would represent an even farer distribution of costs on a per pax basis.

Environmental Sustainability

IATA understands that meeting the challenge of climate change will require the collective efforts of the entire aviation value chain including airports. Dublin Airport can maximize its contribution to environmental sustainability by ensuring that its infrastructure costs do not impede airlines' own ability to invest in new fleets, fuels, and technology. This can best be done by retaining a sharp focus on costs and efficiency while choosing those green investments that can make the biggest difference and are based on a sound business case. Airport green infrastructure investments will be needed, but they should be held to the same standards and scrutiny as other capital spending plans to ensure the best possible results.

Financing and financial viability

Adjustments financial viability need to be carefully assessed and only application solely when it is in the benefit of consumers. As explained in the first section of this submission (Approach to Regulation), it needs to be justified for the right reasons. For instance, the potential shareholder's inability to inject equity into the company cannot be a reason for a financing adjustment.

We note that the CAR is currently considering three potential alternatives for dealing with such adjustment:

- Loss recovery: We do not see any justification for a loss recovery adjustment. Dublin airport has always been remunerated for the risk it bears. Moreover, the CAR has already intervened in favor of the airport, and we do not see justification for further adjustments.

- Aiming up: An artificial increase in the WACC implies an unjustified increase in charges for consumers, and we would not be supportive such an approach.

- Depreciation reprofiling: So long as it is "forward-looking" this could be acceptable mechanism for making a financing adjustment, given its NPV neutral nature. However, further discussions are necessary to ensure that the adjustment is needed and that it will not dampen demand.

Quality of Service

IATA agrees with CAR's proposals and supports the Quality-of-Service scheme to ensure consistent performance and efficiency. The targets and measures may need to be reviewed to confirm that they represent the expected level of quality and whether performance is accurately captured. For example, it should be confirmed that queue performance, is being measured from where the line, and not the process, starts.

In terms of principles, it should be kept in mind that the incentives should be referred to as rebates, not penalties as it is a partial refund for services not delivered. Furthermore, no bonus should be considered as what airlines expect from the airports is the performance that they pay for through aeronautical charges – nothing more and nothing less.

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