SUBMISSION BY AER LINGUS IN RESPONSE TO CP3/2009 - DRAFT DETERMINATION ON MAXIMUM LEVELS OF AIRPORT CHARGES AT DUBLIN AIRPORT

Introduction & Summary

This submission has been prepared by Aer Lingus in response to the Commission's draft determination of maximum airport charges at Dublin Airport (CP3/2009). The matters raised here are in addition to any points raised in the Dublin Airport Consultation Committee (DACC) reply to the Commission.

In our response to the Commission's consultation on charges (CP6/2008), we raised a number of concerns, which can be summarised as:

- The need for the Commission to adopt a long-term pricing approach to prevent charges oscillating unnecessarily in response to short run demand factors.
- The fact that Dublin Airport is expensive and inefficient in terms of operating costs.
- That Dublin has also been very inefficient in terms of its capital investment, especially as regards least cost long term, planning and the development of an over-specified and over-priced T2.
- The potential for an inappropriate *structure* of charges to emerge at Dublin Airport, in particular with respect to T2.

Our view is that the Commission's draft determination does not adequately address any of these points.

Overall, the proposed determination, by allowing an immediate increase in maximum charges from €7.39 to €8.35, does not reflect the reality of the current economic conditions and in our view fails adequately to balance the interests of the airport operator and current airport users. This situation will be exacerbated by the fact that the determination includes a number of significant capex triggers that could lead to further escalation in airport charges.

The determination also appears to establish the principle that the DAA will be able to recover additional operating costs for T2 over and above those included in the determination, leading to yet further escalation in future airport charges. It is our view that these open-ended proposals also fail to protect prospective as well as current airport users.

Furthermore, while we are concerned at the levels of costs being allowed for Dublin Airport, our view is that the lack of detail provided CP3/2009, combined with the extensive redactions of data that is claimed to be commercially confidential, means that Aer Lingus is not in a position to comment effectively on all of the detail of the draft determination.

In addition to these over-arching points, Aer Lingus has concerns about the approach the Commission has taken to a number of other key issues including:

- Use of subjective measures for assessing DAA's quality of service, combined with lack of sufficient incentive to ensure DAA is motivated to achieve the necessary standards.
- The Commission's methodology for the calculating the RAB and how this has been applied to arrive at the starting 2009 figure.
- The Commission's view on DAA's cost of capital and financeability issues.

The Draft Determination and the CAR's approach to regulation

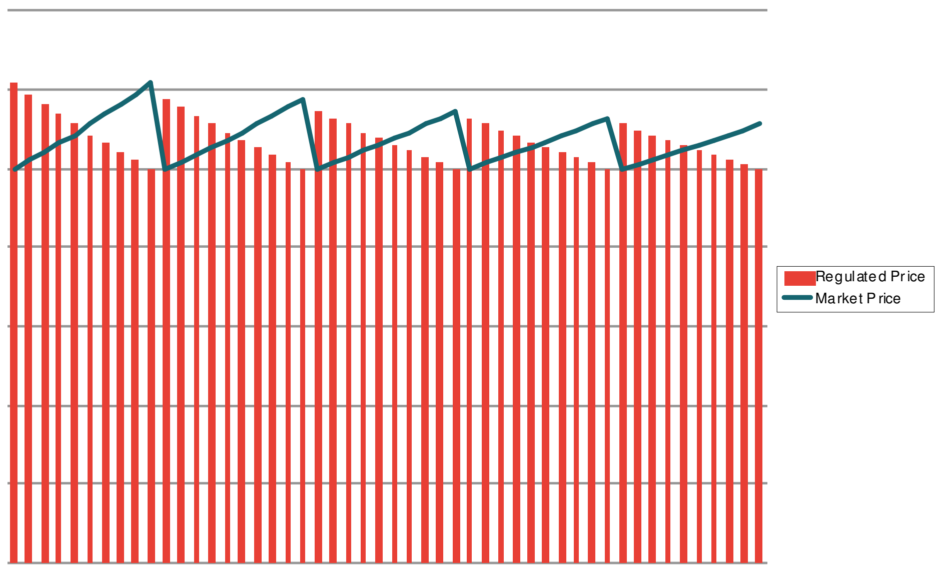
The draft determination allows for an immediate increase in Airport Charges in 2010 from €7.39 to €8.35, an increase of 13%. While recognising that the recent fall in passenger numbers is a contributory factor in this increase, Aer Lingus's view is that such an increase is neither appropriate nor necessary in the current economic climate.

In a competitive market it is to be expected that prices fall rather than rise during times of weak demand. The Commission's draft determination achieves precisely the opposite. Indeed at paragraph 4 of the executive Summary the Commission is explicit in noting that the average price cap is 18% higher than it would be had the 2007 passenger demand forecasts remained valid.

This is a well known and much discussed feature of this form of building-block approach to regulation that the Commission has adopted, occurring particularly in the event of major investments that individually represent a significant proportion of the regulated airport's asset base.

In our response to CP6/2008 we highlighted this fact and illustrated the contrast between the maximum charge likely to emerge from a building blocks approach and a market-driven price. This chart is reproduced below.

Figure 1. Illustration of contrast between market pricing for airport capacity and regulated short-term pricing, based on RAB



We recognise that under the RAB-based approach that there may be *some* increase in maximum charges arising from a downturn in demand unless costs are reduced. But because of the mismatch between this tendency and the appropriate competitive outcome, it is essential that the Commission does everything it can to try and offset this tendency.

We further acknowledge that, in some respects, the Commission has attempted to address this tendency, by unitising depreciation for T2. But in our view this approach has not gone nearly far enough and the result is a proposed increase in Airport Charges that is unacceptable to airport users in the present conditions.

The fact that the unitisation has an inadequate impact on prices, and does not achieve the long run stability airlines are seeking, is illustrated by the Commission's emphasis on the impact of the downturn in passenger numbers on prices. At para. 4 of the Executive Summary the Commission attributes an 18% increase in airport charges to the fall in passenger numbers, but it is not at all clear how such a figure has been derived.

First, we assume that the 2007 figures referred to are the demand forecasts used for the 2007 interim determination. But comparing these figures to the demand forecast in the current draft determination shows that predicted passenger numbers from 2010 to 2014 are 18% lower in total than was predicted in the 2007 Interim determination.

This immediately implies two things. First, that the Commission's draft determination contains no opex and capex reductions in the coming quinquennium as a consequence of the fall in demand. This does not seem credible. We doubt it is the Commission's intention to imply this.

The second implication is that the Commission, despite unitising T2 depreciation has, in effect allowed DAA to recover virtually all of its loss as a result in the fall in passenger numbers during the five years of this determination. We are further concerned that the Commission may also have failed adequately to adjust operating costs for the fall off in passenger numbers. At paragraph 7.10 the Commission identifies the cost elasticities it has used for forecasting with respect to passenger numbers. But it is not clear that the Commission has also applied these factors to the airport's opening opex position to ensure that DAA only being remunerated for efficiently incurred costs.

In our response to CP6/2008, we outlined a number of options that the Commission had available as part of a coherent long-term pricing policy that goes well beyond unitising T2 depreciation. Such an approach would stabilise prices to a far greater degree than is implied by the Commission's determination but would nevertheless ensure that DAA would be able to recover an adequate return on efficiently incurred investment (which for the avoidance of doubt would include a T2 of an appropriate scale). The Commission does not appear to have responded to our proposals or explored the possibility of applying them.

To reiterate, it remains our view that to approximate long run efficient pricing it is essential that the sum of depreciation *and* capital return be regulated on a per passenger basis, not merely the depreciation element. In this way total capital related costs are smoothed over time (rather like mortgage payments). Furthermore, the Commission could also consider extending the payback periods for investment to reflect the deferral in the growth of demand caused by the global recession. This would create even greater price stability while maintaining the regulatory assurance that efficiently incurred investment will be adequately remunerated.

Our view is that this sort of long term pricing is consistent with economic efficiency and provides more than adequate risk protection to the airport's investments because it embodies a *commitment* on the part of the Commission to allow the airport to recover a fair return on its investment in the long run (subject obviously to the requirements that the airport operates efficiently and provides a good standard of service).

To give a numerical example, of how a long-term approach to pricing mitigates the effects of a downturn in passenger numbers, we estimate that an 18% passenger downturn during the coming 5 years amounts to approximately a 6%

loss in total passenger numbers over a 40 year period[1] and would require a c. 11% price increase, other things being equal, to ensure full cost recovery over the 40 year life of an asset. Furthermore, by flexing the payback period by a further 5 years the shortfall could be reduced to 8.8%.

Hence by smoothing prices over the long term, and flexing the payback dates on total cost recovery, it is possible to reduce substantially the impact on prices of any short term demand fluctuations. In addition, once cost savings are taken into account, the smoothing becomes more pronounced. For instance, if we are to assume that the elasticity of total costs with respect to passenger numbers is 0.5 on average (just for the purpose of illustration), then an 18% demand reduction would only translate into an 11% increase in cost per passenger if confined within the quinquennium, but this falls to 6% if spread over the asset life and to 4% if the payback period is also extended by 5 years.

Quality of Service

Aer Lingus is generally supportive of the Commission in introducing quality of service targets for Dublin Airport and rebates for failing to achieve these.

Aer Lingus remains of the view that what is needed is a full Service Level Agreement on DAA, enforced by the Commission with strong rebates where the DAA fails to provide the agreed level of service. These service levels must be defined from both a passenger and an airline perspective. The Commission's current proposals fall short of a full SLA.

Related to this point is the fact that the list of measures the Commission intends to monitor is limited and does not cover the full range of issues that impact on airlines in particular.

We would favour a more extensive set of measures, based, wherever possible, on objective measures such as those set out in the response paper of the DACC (Service Quality and Rebates at p. 46).

We remain concerned that the subjective survey measures on which the Commission plans to rely will not adequately reflect the airport's true performance. Furthermore, we consider that, in all likelihood the financial incentives proposed are too small.

---

1 This calculation depends on the assumed average rate of growth in passenger numbers and the maximum capacity of the existing facilities. We have assumed 3% p.a. and 35m passengers (unconstrained by issues of runway capacity).

Passenger forecasts

We have no specific comments on the passenger forecast used by the Commission, other than to reiterate that, in our view, the Commission should adopt a long-term approach to price setting that substantially smoothes out the impact of short term demand fluctuations on the maximum level of charges.

Operating costs

Aer Lingus considers that matters relating to Dublin Airport's operating costs are largely addressed in full by the DACC's response to CP3/2009.

Our primary concern remains the costs that the Commission is prepared to allow with respect to T2. While Aer Lingus is generally supportive of the development of T2, in our view it is not appropriate for the Commission to adopt a cost pass through approach to additional costs generated by the new terminal. We are particularly concerned that the Commission's proposals leave uncertain the level of operating cost of T2 to be passed on in airport charges. But the clear presumption in the draft determination is that overall costs will rise. We do not think that this should be the case.

First, we note that it is only appropriate for the Commission to allow *efficient* operating costs. Because T2 is over-sized it is inevitable that actual operating costs will be higher than the efficient level. So as a matter of principle the Commission should be using benchmark costs not actual costs for T2. In our view the Commission should allow a level of costs that is consistent with an efficiently run terminal of the size specified as appropriate by the Commission's consultants.

Second, we consider that the Commission's approach to adjusting allowed operating costs after the opening of T2 is inconsistent and does not promote efficiency.

Our understanding is that on the opening of T2 the Commission will reduce T1 opex according to the elasticities specified in its report, applied to the reduction in T1 traffic. But opex for T2 will then be added in two different ways, depending on whether the service in question is competitively tendered or offered by DAA itself. In the former case the Commission appears to be proposing cost pass through of the competitively tendered contract, in the latter case the Commission says it will set a "reasonable cost estimate" (para. 7.19), but does not specify what methodology it would use for determining "reasonable".

We have a number of objections to this process.

- By treating contracted out opex and in house opex separately at T2 the Commission is creating a two-tier regulatory system where the two types of opex are being treated differently for regulatory purposes. This may distort the DAA's decision as to what is or is not contracted out.

- It is not good regulatory practice to allow cost pass through for costs simply because the activity is contracted out. Many activities at regulated airports are contracted out while remaining the responsibility of the airport operator. If the DAA and all interested bidders know that contracted out services are effectively subject to cost pass through the effect will be to remove the pressure to be as efficient as possible from the competitive process. It is therefore common practice among other regulators to set benchmark opex regardless of which specific services are contracted out.

- The treatment of T2 opex *increases* is different to the Commission's approach to T1 opex *decreases*. The latter seems to be based on benchmarks and reflects, at least in principle, the idea of efficient costs adjusting to passenger numbers. The former appears to be based on a bottom up assessment of the actual costs at T2. There is no guarantee therefore that the aggregate allowed costs for T1 and T2 combined will be either efficient or reasonable.

- In particular, the approach is illogical, because it applies long run efficiency principles to the reduction in opex at T1 but not the same principles to the opex at T2. In our view these principles should be applied to both. This would involve applying long run elasticity estimates to aggregate opex.

As a reference point for efficient costs and what should be expected to happen to costs on the opening of T2, we think the Commission should consider the evidence from the opening of the second terminal at Manchester Airport. This is relevant because it is recent evidence from a similar airport operating in similar economic conditions and the new terminal at Manchester was the same size as the Commission's own advisers considered was required to meet Dublin's needs.

Commercial revenues

Aer Lingus considers that the extensive redactions from the section on commercial revenues make it very difficult to review the Commission's judgement with regard to commercial revenues.

Capital costs

RAB Principles

We welcome the fact that the Commission has set out the principles that will be adopted in future for determining the opening RAB at the start of any regulatory period. These are set out in Annex 1 of the draft determination.

On the whole, the principles set out there seem to be reasonable. Our view, put simply, is that money assumed by the Commission in DAA's capex plan that is not subsequently spent should not remain in the RAB. Furthermore, the conditions under which it is possible for DAA to spend money outside what was agreed in the determination and get that added to the RAB should be extremely limited.

We agree under scenario 1 that genuine efficiencies in investment should be removed from the RAB at the next appropriate price review, but previous savings should not be clawed back, so as to avoid dis-incentivising the DAA from making efficiencies.

Under scenario 2, we agree that costs incurred above the forecast level should be excluded from the RAB if these are due to inefficiency. If, however, these additional costs are due to a change in specification or factors outside the DAA's control the Commission should be very careful before considering adding the additional expenditure to the RAB. We strongly agree with the proposition that a change in specification can only be used to justify an increase to the RAB if the DAA can provide documentary proof that airport users were aware of the change and its cost, were still supportive of the change *and* had formed these judgements before DAA had committed to the additional expenditure. This should be a very high burden of proof for DAA. Where over-spend relates to factors outside the DAA's control, we think the Commission should make a careful distinction between changes in impact of new regulatory laws or standards – e.g. security, planning procedures, etc., and general cost movements (e.g. construction cost inflation). In the former case it may be reasonable to allow additional costs in the RAB. But in the latter case, cost movements are simply a business risk that the airport operator has to accept. These risks are already reflected in the cost of capital allowed. The presumption should be against including such additional costs in the RAB.

We consider that the situation concerning the link between Pier B and T2 falls under this scenario. The link is an essential element of the capital project and the services that it will provide. The DAA has stated that the efficiency of both terminals would be compromised by the absence of such an effective connecting mechanism as well as the negative impact of additional bus traffic (c. 278 movements per day) on apron activity. The omission by DAA of the cost of the link from the agreed capital cost of the project appears to us to be clearly a factor that was inside its control. If this omission were pointed out at an earlier stage, it is possible that it could have led to a redesign or lower cost solution Therefore we consider that the Commission should follow the principles set out in the Draft Determination and not make additional allowance in the RAB for the overspend.

Furthermore, DAA's current position is that if the airlines do not support the construction of the link then DAA will not build it. This approach is unacceptable. The link is a core and fundamental element of the T2 project. If the link is not constructed then T2 will not be fit-for-purpose and in the absence of such a link, Aer Lingus will not be in a position to operate out of Terminal 2. No cost recovery should be allowed for expenditure on a project that is not delivered in a manner that is fit-for-purpose for an airline to use. This is consistent with standard regulatory principles regarding the treatment of investment that do not deliver the required outputs and is in line with the proposed treatment under scenario 4.

Further comments on the cost of T2 are covered below.

Under scenario 3 we agree that the appropriate response to an under-spend combined with non-delivery of outputs is to claw-back the past expenditure allowance as well as striking the sums from the RAB.

Starting 2010 RAB

Although we broadly agree with the principles set out in Annex 1, we do not feel that the Commission has applied these principles in an appropriate way to the definition of the 2010 RAB. As a consequence we feel that this starting figure has been over-stated in the draft determination.

In particular we are concerned about the treatment of Pier D and projects not included in the 2006 CIP.

As regards Pier D, the walkway cost overruns described by the Commission may not have been within the airport's direct control, but seem to us simply to relate to the intrinsic uncertainty in predicting some cost elements. This forms part of the risk the airport should be expected to bear within its cost of capital

As regards costs outside the 2006 CIP, in our view, only the Section 49 contributions fall within that definition of changed circumstances that merits inclusion in the RAB. As for the other additional expenditures, the Commission does not present evidence of support for these items from airport users and advance knowledge of their cost. It seems therefore that these elements do not meet the criteria the Commission has set itself under scenario 2 of Annex 1. We believe therefore these elements should not be included in the 2010 RAB.

T2 Costs

The subject of what level of T2 costs to include in the RAB raises a number of related issues.

First, in line with the Commission's own advisers, we believe that T2 is over-specified; at least 40% larger than it need be (RR&V Report No. 4 Review of DAA Terminal Sizing May 2007, Executive Summary at p.6). Because it is not appropriate for the Commission to allow funding of inefficient levels of investment the total allowance for T2 included in the RAB (at whatever point) should be adjusted down to reflect an efficient level of investment.

Secondly, we remain of the opinion that "practical completion" is not an appropriate trigger to allow the inclusion of T2 costs in the RAB. This point relates back to our view on the appropriate long-run level of economically-efficient pricing.

The Commission's approach means that on the day that the terminal opens its full cost will be carried by all passengers at Dublin even though there will be no incremental increase in traffic. This is economically inefficient. Furthermore the Commission's argument that users are benefiting from T2 and therefore should contribute towards its cost does not really follow either. Once T2 is open it is reasonable for airport users to spread out throughout all the existing terminal space and all users, whether in T1 or T2 will gain some benefit from the reduction in congestion. But this benefit is small as there is no evidence to suggest passenger numbers will increase because of the reduced congestion or that airline ticket prices will increase.

The economically rational approach to pricing would be to recover the costs of T2 from the actual incremental growth in passenger numbers *facilitated* by T2. [2]

As we have pointed out previously, the point of congestion at Dublin is the runway, not terminal capacity, so T2 will release little or no incremental capacity until the second runway is complete. Hence our suggestion that the Box 1 trigger point for T2 should be the completion of the second runway.

The Commission has rejected this proposal by saying that such a trigger would create a perverse incentive for DAA to develop the second runway too early. Our view is this would not be true if the Commission adopted efficient long run pricing for the runway as well. If it were to do this then the cost of the runway would be recovered over the incremental passenger traffic facilitated by the

---

2 We note that the deferral of 27% of the capex cost of T2 to Box 2 does not solve this problem. It remains the case that the capex in Box 1 exceeds the size specified as efficient by the Commission's own advisers. Furthermore, even if this were not the case it is still economically efficient to unitise the full cost of the terminal across the incremental traffic it generates. The Commission's approach remains inefficient although it reduces slightly the iniquity of expecting passengers today to meet ht cost of all T2's initial spare capacity.

runway. Until that traffic is generated there would be no cost recovery. Hence under a long run economic pricing rule there is no incentive to build assets before they are needed. Aer Lingus is of the view that should the Commission continue to discount our proposal that the Box 1 trigger point for T2 should be the completion of the second runway, then that trigger mechanism set out at paragraphs 94-96 of the response paper of the DACC to CP3 of 2009 is appropriate.

Post 2009 capex

Aer Lingus's views on post 2009 capex are represented in the DACC's response to CP3 of 2009.

Cost of Capital & Financial Viability

Aer Lingus is supportive of the overall methodology used to assess the cost of capital. In particular, we consider that the Commission is correct to focus on medium to long-term trends in the data and not to attach undue weight to recent financial market conditions. This is appropriate given the long-term nature of the assets and the regulatory system.

However, we consider that the Commission has overstated the degree of risk faced by DAA and has therefore chosen an excessive Beta value that results in a cost of capital that is too high.

We would make the following observations regarding the risks faced by DAA.

- The Commission argues that the airport business has become riskier as a result of recent economic conditions (para 9.89). We consider that this effect has been overstated. It is important to distinguish between experiencing a risky event and a change in long-term riskiness. We do not accept that current events have resulted in a change to the long-term riskiness of the airport sector. A change would be confined to the recent and short-lived 'irrational exuberance' of some investors that has now come to an end. This has no impact on regulatory decisions on the cost of capital.
- The Commission refers to the UK Competition Commission decisions on the asset Beta for London airports – covering Heathrow (0.47), Gatwick (0.52) and Stansted (0.61). The Commission has applied the figure of 0.61 for DAA, the same as the figure for Stansted. We contend that Dublin Airport is subject to less risk than Stansted and, in particular, less exposure to competition. The Commission's own analysis shows that Dublin has been less affected by the downturn than Stansted has.
- Overall, although we consider that the UK evidence is relevant we believe that it supports an asset Beta below 0.61 and closer to the assessed asset Beta for Gatwick.

We also consider that the real cost of debt of 4.1% is too high and not supported by the full range of available evidence. For example, the data on European corporate bonds used by the Commission, indicates that the real cost of debt of an A-rated issue is currently around 3.2% (para 9.95). As the Commission highlights, this rating is consistent with the rating of DAA's bond. There is no case to support a figure higher than the range allowed for Stansted (3.6% to 3.9%).