



Brussels, 23 March 2011

Gérard Borel
General Counsel

Mr John Spicer
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Ireland

Dear Mr Spicer,

On behalf of ACI EUROPE I am pleased to submit a response to the Commission for Aviation Regulation's consultation process on the definition of the regulatory till at Dublin Airport.

ACI EUROPE is the European region of Airports Council International (ACI), the only worldwide professional association of airport operators. ACI EUROPE represents over 400 airports in 46 European countries, including Dublin Airport. Member airports handle 90% of commercial air traffic in Europe, welcoming nearly 1.5 billion passengers each year.

ACI EUROPE is committed to engaging with regulators at both at a European and national level, to lend industry experience and expertise to decision makers, and so welcomes the opportunity to participate in the Commission's current consultation.

I hope you find ACI EUROPE's submission of interest and of use in the Commission's coming deliberations on the nature of the regulatory till at Dublin Airport.

Should you require any clarification or elaboration on any of the points contained within, or indeed on any wider points concerning the European aviation industry, I trust that you will not hesitate to make contact with us.

Yours faithfully,



**ACI EUROPE Submission to the *Commission for Aviation Regulation*
Concerning the Definition of the Regulatory Till at Dublin Airport**

23 March 2011

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Introduction

Airports Council International Europe (ACI EUROPE) represents the interests of over 400 airports in Europe across 46 countries and has extensive experience in playing a constructive role in the formation of aviation policy, including the recent European Union's Airport Charges Directive. We therefore welcome the opportunity to participate as an interested party in the Commission for Aviation Regulation's (the Commission's) consultation process on the nature of the regulatory till at Dublin Airport. ACI EUROPE views the issue from the perspective of the wider European aviation industry, and sees strong policy implications associated with the issue of the regulatory till.

European airports are increasingly facing the challenges of intensified competition, while still being required to provide extensive capacity to meet demand for air services in the decades ahead. In many cases, economic regulation is becoming 'caught in the middle'. Elaborate regulatory systems, beyond that outlined in the EU's Airport Charges Directive, are not always tailored to the local balance of power in airport-airline relations. This adds distortions and gaming opportunities, and pushes the level of airport charges away from the optimal market clearing rate, raising additional barriers to the provision of much needed capacity.

The obligations of the Airport Charges Directive place the onus for regulation of airports at a national level, leaving responsibility with national regulators or 'Independent Supervisory Authorities'. The European aviation industry needs to be regulated in a manner which reflects the business environment it is operating within, and it is only national regulators such as the Commission which can do this.

As the industry evolves, it is the maintaining of a level playing field and protecting end users i.e. passengers, which should be to the fore of regulators' considerations. While different regulators may have different statutory obligations to observe, these should be considered in the context of producing the best possible welfare outcome. Under-regulation undermines economic efficient outcomes, by introducing the risk of abuse of market power. Yet over-regulation is equally threatening, distorting the market and introducing potentially damaging disincentives. The regulator's challenge is to find the correct balance which mimics a competitive outcome.

In this context ACI EUROPE believes that the Commission should adopt the 'economic approach' proposed as a guiding principle in paragraph 4.40 of CP4/2010, and only regulate those services for which the airport enjoys market power beyond that normally controlled by existing Irish and European competition law.

Context

The issue of airport regulation is becoming increasingly contentious at a European level, and this has been reflected in the recent Airport Charges Directive. Developments in the nature of the aviation industry, as well as projected significant shortfalls in capacity, mean that there are no longer many simple answers in this field. While economic regulation remains a central component of Europe's approach towards airports, the emerging challenge in this new business environment is to ensure

that over-regulation does not stifle the future of the industry, nor distort or undermine existing aviation markets.

The liberalisation of the European aviation industry has changed not only the environment which airports operate within, but also the very nature of airports themselves. Twenty years ago airports were mere infrastructure providers, dependant on public finances and essentially focused on the interests of their country's flag carrier. Today airports are diversified and complex businesses, independently operated and largely self-financed¹.

Within Europe, the rise of the Low Cost Carrier (LCC) model means that airports must respond to their customers' needs, or face a rapid redeployment of aircraft and crew at short notice to competing locations. Indeed, the market share of some LCCs at certain airports severely circumscribes any market power which these airports may have once had. Dublin Airport is a case in point. 79% of all Dublin Airport traffic is controlled by LCC operators. While much work remains to be done in this area, the future of aviation regulation may find itself more concerned with monopsony power and its associated welfare implications, rather than the traditional monopoly power implications. Recent moves by the UK's Office of Fair Trading to investigate the relationship between Ryanair and Aer Lingus underlie this².

Beyond Europe's borders, the potential for growth rests with airlines from emerging markets. These airlines face a 'Europe-wide airport superstore' with airports vying to provide the best deal. Dublin Airport is recognised as being a dynamic player within this market.³ The new reality is that airports compete against each other, and face correspondingly reduced market power in their negotiations with airlines.

In response to these new competitive pressures, airports are developing new business models away from the traditional ones. Alongside price, airports are competing by tailoring their product to suit niche markets. A range of different models have emerged, such as airports focused on freight, airports with particularly strong intermodal links, and airports tailored for business passengers.⁴ ACI EUROPE commends the Commission for its decision to allow DAA the required flexibility to drive forward with its own innovation in the 'Dublin Airport City' project.

The effects of this new competitive environment can be seen in industry figures for 2009. While aeronautical revenues were €13.9bn (versus €12.1bn for non-aeronautical revenues), overall costs were €25.9bn (comprised of €18.6bn operating expenditure and €7.3bn of capital costs)⁵. Given the normal costs associated with providing capital-intensive aeronautical services, alongside the high

¹ In 2010, 80% of European airports were operated as corporatized business entities. Please see the recent ACI EUROPE report on 'The Ownership of Europe's Airports 2010' for further information. <http://www.aci-europe.org/upload/ACI%20EUROPE%20Airport%20Ownership%20Report%202010%20LR.pdf>

² 'Ryanair minority stake in Aer Lingus: OFT believes it is 'in time' to consider acquisition', Office of Fair Trading press release, 04/01/2011, <http://www.of.gov.uk/news-and-updates/press/2011/01-11>

³ http://articles.economicstimes.indiatimes.com/2011-03-18/news/29141866_1_frankfurt-hub-new-hub-air-india

⁴ For further information and more examples of airport business models see 'An Outlook for Europe's Airports – Facing the Challenges of the 21st Century', ACI EUROPE, available at http://www.aci-europe.org/upload/Challenges-Brochure_FINAL_lowres.pdf

⁵ 'Economics Report 2010', ACI EUROPE, Currently in publication & to be available at www.aci-europe.org

security operating costs⁶, it is apparent that airlines are paying a price for aeronautical services which does not fully cover the associated costs.

As a result, airports' ability to plan for the future is being squeezed tighter and tighter, at precisely the worst possible time. Europe is facing a serious capacity crunch. EUROCONTROL estimate that by 2030, 10% of demand for air services will not be accommodated. This will impact around 2 million flights.⁷ While local planning restrictions play a role, the financing of necessary capacity projects remains a key impediment. Airlines will need to pay a fairer share of the services they consume. Airports cannot continue to subsidise airline operations to the current extent indefinitely.

Worryingly, other regions are not facing these constraints, exemplified by the spate of airport capacity currently being created in the Middle East, China, and further afield. In all probability, by 2030, none of the world's 10 largest airports will be located in Europe.

Such considerations were reflected in the EU decision making process which led to the EU Airport Charges Directive. Prescriptive detailed regulatory requirements are avoided. There is a recognition that any regulation of airports below a certain size would be damaging to both society and the economy. Obligations are placed on both airports and airlines, reflecting new distribution of power between the two parties.

Broad principles for the levying of airport charges are laid out. This ensures that there is no question of the Directive prescribing heavy-handed or overly intrusive regulation in situations where the presence of undue market power has not been established. Rather the Directive sets minimum standards for the economic oversight of airports throughout Europe, and allows for a harmonised approach between Member States. Beyond Europe, the policy recommendations adopted by the International Civil Aviation Organisation (ICAO) also take a neutral stance on the issue of the nature of the regulatory till.⁸

At the same time, there has been a move towards more focused regulatory regimes across Europe. ACI EUROPE notes the Commission's use of its 2006 SH & E report; however since 2006 fewer regulatory regimes can be said to be 'single till', as regulators increasingly hone their activities in on the specific operational areas where market power actually exists. For example, both Paris Charles de Gaulle and Brussels Airport have begun moves towards a hybrid till in recent times.

The Role of Regulation

Price cap regulation in its current form is not helping to resolve the above challenges. Airlines remain strongly incentivised to lobby for unrealistically low airport charges, secure in the knowledge that the resulting infrastructural deficit will protect their market position from further competition. Even were one to dismiss this as cynical commentary, it remains true that in a volatile environment such

⁶ The same report shows that security costs alone represent 29% of total operating expenses

⁷ *Long Term Forecast – Flight Movements 2010 -2030*, EUROCONTROL, <http://www.eurocontrol.int/statfor/gallery/content/public/forecasts/Doc415-LTF10-Report-Vol1.pdf> (Growth Scenario 'C')

⁸ See for instance 'ICAO's Policies on Charges for Airports and Air Navigation Services '(ICAO Document 9082), http://www.icao.int/icaonet/dcs/9082/9082_cons_en.pdf.

as the airline industry, airlines' incentives to pay for necessary investments are weak at best, when the resulting infrastructure may benefit a rival, or may never benefit the airline itself.

Airports need to remain incentivised to deliver adequate investment in capacity in the years ahead, and this requires European aviation authorities at all levels, European and national to tailor economic regulation to the current competitive state of the industry. It is incumbent upon authorities such as the Commission to ensure that its policies support efficient market outcomes, which take full account of the long-term sustainability of the industry. Subsidised airport charges may keep airlines content, but if those charges are over-stimulating demand, and not allowing an adequate infrastructure to be provided, then they are neither efficient nor sustainable, and are damaging to social welfare.

In an industry where the balance of market power is increasingly unclear, economic regulators can best serve the common good by regulating only in areas where there is evidence of market inefficiencies resulting from the disproportionate pooling of market power. To do otherwise risks further distortions, and the unnecessary and inherently highly political arbitration as to who gets what rent transfer. Regulating only where necessary is an inherent part of efforts to ensure fair competition and ultimately to maximise economic welfare, and is central to all attempts to create pricing signals equivalent to those which would result in a fully competitive non-regulated environment. This will allow the optimal economic welfare outcome to emerge.

The Commission has stated that its statutory objective and ten factors to which it must have 'due regard' will be considered in the context of maximising economic welfare.⁹ ACI EUROPE supports this approach. As industries and businesses evolve, optimising economic welfare will remain the constant principle by which regulatory policy can be determined, and will ensure that regulators are providing the maximum possible return to the communities which they serve.

The correlation between proportionate regulation and welfare gains has been shown before in the aviation industry. The number of air routes within the EU has increased by 170% since the creation of a single aviation market in 1993.¹⁰ Liberalisation also enabled airports to embrace competition. When parties were free to charge and pay the true market clearing cost of services, players were enabled and incentivised to innovate and find the most efficient means of production. These results could never have been achieved by regulation alone. The recent death of Dr. Alfred Kahn triggered a wave of commentary on the benefits that have resulted from more circumspect regulatory involvement in the aviation industry.¹¹

In line with this, ACI EUROPE believes that the Commission should use the 'economic approach' as the guiding approach when determining the extent of the regulatory till, and only regulate areas of Dublin Airport Authority's business where there is clear evidence of market power. While other approaches referenced may have attractions from an application point of view, none deliver the economic efficiency nor the legitimacy that the 'economic approach' provides.

⁹ Page 25, "*Economic Regulation of Airport Charges In Ireland – CP2/2001*", Commission for Aviation Regulation, February 2001

¹⁰ '*Flying Together*', EU Air Transport Policy 2007,

http://ec.europa.eu/transport/air_portal/international/doc/brochures/2007_air_transport_flying_together_en.pdf

¹¹ http://www.economist.com/node/17956457?story_id=17956457

Balanced Regulation & Optimal Outcomes

ACI EUROPE believes that the various arguments advanced surrounding the composition of the price cap building blocks are in reality largely arguments surrounding the implications of over and under regulation, or alternatively, the balance between the risk of abuse of market power and the inefficiencies of overly-invasive regulation.

The Commission has asked respondents to comment on the merits of the various arguments it has presented. ACI EUROPE believes that the arguments which are most related to the above balance between abuse and inefficiency are the most consequential, and therefore the most important. Arguments concerning administrative challenges and ease of implementation remain valid, but are of lesser importance.

Revealingly, all arguments presented by the Commission which reference economic efficiency favour a more focused regulatory scope. This follows naturally from the principle that efficiency is most readily achieved when economic actors react to the correct pricing signals provided by the goods and services which they consume. In an airport context, if users must pay an appropriate price for the aeronautical services they use, then they will not be incentivised to over-consume, and the revenues generated can be used to ensure the continued maintenance and development of the capital and operational inputs required to provide those services.

Theory suggests that focusing regulation exclusively on business areas where market power exists creates optimal economic outcomes while not materially increasing the risk of abuse of market power.

CP4/2010 –Specific Points

The Commission has asked respondents to comment on the relevance of the various arguments outlined in Table 3.1 of CP4/2010. ACI EUROPE has provided some comments below:

Single Till Arguments

'Airport charges may be lower' – ACI EUROPE is concerned by this. The issue for a regulator should not be whether charges are high or low but rather whether they produce the economically optimal outcome. As alluded to before, artificially low charges may be politically desirable, but they are not necessarily economically desirable. If charges are unsustainably low then the long term impact is damaging for both airports and the end users of airports, if not necessarily the airlines. The argument that low charges are desirable in and of themselves is not a valid argument in isolation, and must be secondary to the economic implications if these low prices are in fact not reflective of the true costs of providing the services. In particular it must be borne in mind that airports must be

incentivised to invest in new infrastructure, particularly in light of the European capacity challenge currently emerging.

The role of the regulator is not to ensure a low price but rather a just price.

'Airlines benefit from bringing passengers to the airport' – this is primarily an issue of rent transfer, but also has negative efficiency associations.

As with all industries, aviation has multiple parties, all of which are mutually interdependent. Selecting this particular relationship between two parties as a justification for transferring rents between those parties is arbitrary and without foundation. It could equally be argued that while airlines may attract passengers to airports, it is equally the case that end destinations attract passengers to airlines. There is little inherent value in air trips in and of themselves. Much like using airport facilities, flying is a means to an end. Both airlines and airports are entitled to earn a normal return on investment for their efforts. Were this argument to be accepted it would be equally valid to suggest that rents be transferred from airline profits to the local authorities/tourist boards/local business associations who 'brought the passengers to the airline'.

Aside from this, an airline's runway slots are increasingly seen as comprising the bulk of an airline's value, as acknowledged by the airlines themselves.¹² While arguments may be made as to who 'deserves' what, the reality is that airlines are already freely receiving assets of huge value from airports.

'Reduces incentives to undertake excessive commercial activities' –the incentive to maximise commercial revenues is a product of the wider regulatory structures rather than the specific nature of the regulatory till, and in any case were such activities to materially impact passengers than this would be reflected in the Commission's service quality system.

In addition this argument is symmetrical. If the dual till risks incentivising excessive commercial activities than it must equally be said that the single till risks incentivising insufficient commercial activities. Over-reliance upon the single till by regulators does not encourage airport operators to maximise non-aeronautical revenues, as any rewards for innovation and over-performance are quickly transferred to airlines. Instead airports would be incentivised to provide high-cost services with no accompanying commercial revenue - generating activities.

Without the contribution of non-aeronautical revenues, airports would often not be able to offer a competitive level of airport charges to their customers – the passengers and the airlines. It should be noted that even in a dual till environment where aeronautical and non-aeronautical revenues are kept separate, non-aeronautical revenues can significantly reduce operating costs for aircraft operators at an airport. Profits from non-aeronautical revenues are reinvested in airport infrastructure, reducing the need for airports to borrow money on capital markets and thus lowering

¹² *'IAG 'very interested' in Virgin, but only for slots: Walsh'*, Flight Global, 24/02/11, <http://www.flightglobal.com/articles/2011/02/24/353562/iag-very-interested-in-virgin-but-only-for-slots.html>

capital costs for the airport. In addition, such profits result in better credit ratings, again leading to lower costs of capital.

'Easy to Administer' -the regulation of airport activities where competition exists may present new challenges under the requirements of the Airport Charges Directive. Article 7 of the Directive lists a range of information which the airport operator is obliged to provide to airport users, including the costs, revenues and methodology which inform airport charges. If airport charges at Dublin are to be calculated with reference to areas of DAA's business which are in competition with airport users¹³, then the airport operator is in effect obliged to provide sensitive commercial information to its competitors, without any reciprocating information. This may raise wider administrative challenges.

Beyond this, it is not necessarily the case that the dual till is more challenging to implement. Under the EU Ground Handling Directive, airports who engage in ground handling are already obliged to separate their accounts. Other airports operate, or are moving to operate dual-till and hybrid systems. With modern accounting practices and technologies, the administrative tasks do not represent an insurmountable barrier to the implementation of a more focused regulatory remit.

'Avoids certain forms of regulatory gaming that might arise with a dual till'- as with the argument concerning incentives to undertake excessive commercial activities, the existing service quality system should capture and penalise any meaningful deterioration in service quality.

Under the existing setup airlines are involved in both the approval of DAA's commercial projects and the determining of the Commission's commercial revenue allowances. Clearly airlines are incentivised to argue for the minimal possible capital investment, while predicting the maximum possible resulting commercial revenues. More specifically, airlines are incentivised to lobby for the stranding of commercial assets after the investment has been delivered, safe in the knowledge that they will still benefit from the significant subsidies that associated airport commercial activity subsidising the price cap.

In net terms, the scope for regulatory gaming should logically decrease when regulation is focused only on the areas where it is necessary. It is difficult to see how a more limited regulatory framework, focused only on areas where regulation is necessary, could increase the scope of regulatory gaming.

Dual Till Arguments

'Reduced scope of the airport's business that the regulator has to scrutinise' – for the avoidance of doubt, this argument must be seen as more than simply an administrative or cost advantage. The implication of more focused regulation is that regulators are no longer becoming involved in areas of

¹³ For example airports and airlines compete in areas such as food and beverage, duty-free sales, and the sale of other discretionary items. In addition airlines have commercial interests in areas such as car hire, accommodation, and transport to and from the airports, which are promoted on their websites, and which impact airports' commercial revenues.

business where there is no monopoly power. That outcome is a positive outcome in and of itself, as it does not increase the risk of abuse of market power, yet allows the markets in question to produce an outcome which is as efficient as is possible.

Conclusion

The aim of economic regulation is to ensure a level playing field and to protect the interests of end users, i.e. passengers. Regulatory frameworks can create situations where rents are transferred between parties. This is rarely advantageous in and of itself, and introduces an inherently political element to the regulatory process, as parties wrestle to claim the 'prize' on offer. The Commission is likely to witness such a struggle during the current consultation process.

While the Commission may choose to continue with a broader regulatory scope, and continue to arbitrate between these competing parties on the allocation of the subsidies generated, the results are unlikely to be conclusive, nor unchallenged. The only means of avoiding such endless disputes is by focusing the regulatory remit on those areas where regulation is specifically required. Using proportionate regulation to target the optimal social outcome, while avoiding the political issue of distributional outcomes between industry players, represents the best path of economic regulation.

Time and time again the most economically efficient outcome has proven to be that which is the result of proportional regulatory intervention. Allowing the market to operate, where free competition exists, benefits all players in the long run. Allowing a commercial freedom which is genuinely relative to an airport's market power offers the best solution to any problems which arise, be they at a national or European level.

The current consultation process on the regulatory till offers the Commission the opportunity to define in a more systematic manner the boundaries of its regulatory responsibilities. The current definition for inclusion within the regulatory till - '*sufficient nexus to the regulated business*' - has not avoided uncertainty as to what should be in and out of the regulatory till. The Commission's proposed 'economic approach' offers a clearer alternative. The Commission currently regulates a range of non-aeronautical services while still incentivising maximisation of the associated revenues. This suggests that market power within these areas is not an issue, and the exclusion of these areas from the regulatory scope would not adversely impact the airport's customers.

However a systematic evaluation of DAA's market power in each of its various revenue streams may have implications beyond the regulatory till. As articulated above, in airline/airport relations, the balance of power has completely changed over recent years, with airlines and airline alliances often being the dominant party in negotiations. The Commission may find that DAA's real market power has diminished significantly since the advent of economic regulation in 2001.

Should this be the case, the Commission could consider a shift in roles. Currently the Commission is very closely involved with DAA, with a requirement to make minute and detailed decisions on a range of building blocks which form the price cap. A shift to the role of the 'independent supervisory authority' as envisaged in the Airport Charges Directive might prove a more appropriate means of regulating Dublin Airport.

The Airport Charges Directive was the result of a long and comprehensive consultation process involving industry players from all across Europe. It marries the requirement for airport regulation with an awareness that intensive regulation is detrimental to all. Due to be implemented at the time of this consultation process, it takes full account of the current state of play of the aviation industry in Europe, and with its obligations upon both airports and airlines, is fully cognisant of new balance of market power in the industry. Having played a constructive role in the formulation of the Directive, ACI EUROPE remains at the Commission's disposal should the Commission wish to discuss this further.

Finally ACI EUROPE would also be pleased to discuss with the Commission in more detail recent developments in the European airport sector which are of relevance to this submission.

To summarise, ACI EUROPE believes that the Commission should:

1. Adopt an 'economic approach' as referenced in Para. 4.40 of CP4/2010 and only regulate activities in which DAA has significant market power, beyond which can be regulated under wider Irish & European competition law
2. Undertake a systematic analysis of the various aeronautical and non-aeronautical activities at Dublin Airport, to determine exactly which areas require regulation
3. Consider adopting lighter regulation, in line with the recent EU Airport Charges Directive, should it determine that Dublin Airport no longer holds the market power that it deemed existed in the past