‘Response to Airports Charges Draft Decision Paper’

ACI EUROPE

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ACI EUROPE is the European region of Airports Council International, the only worldwide professional association of airport operators. ACI EUROPE represents over 450 airports in 44 European countries. In 2012, member airports handled 90% of commercial air traffic in Europe, welcoming over 1.6 billion passengers, 16.7 million tonnes of freight and more than 16 million aircraft movements.

Our members consist of Dublin, Cork, Kerry, Knock and Shannon Airports from Ireland, as well as a wide range of competitor airports from across Europe. As part of our duties to our members, ACI EUROPE is committed to pushing for a level playing field for European airports, so that our members are free to compete under broadly equivalent regulatory frameworks.

Introduction

From previous engagement[1], CAR will be familiar with the views of ACI EUROPE on the emergence of a significant competitive dynamic between European airports in recent years. ACI EUROPE strongly believes that economic regulation in parts of Europe has yet to take account of these competitive pressures (as evidenced by the limited number of regulatory frameworks which are based upon market power assessments) and that more flexible regulatory approaches are likely to be the end result once this has been corrected.

However given the advanced stage in the current process that the draft Determination represents, as well as the detailed and technical nature of the document, in this response we instead focus on what approaches should be adopted when regulators do decide to take an active role in strategic decisions concerning the operation of the airport. Dublin Airport is something of an outlier in regulatory terms – for example it is the only airport in the region which operates under the same framework as that which London Heathrow operates within, with a similar degree of intervention by the regulator, despite occupying entirely different positions within the market.

[1] See ACI EUROPE’s contributions to CAR’s consultation on the nature of the regulatory till at Dublin Airport

Putting aside the arguments as to whether this is or is not a desirable situation, the fact remains that this level of regulatory intervention involves the regulator in effect taking key strategic and operational decisions concerning the airport's management.

While the traditional argument concerning price cap regulation was that the regulator merely choses an upper price level, and that the airport operator has a wide degree of commercial freedom within this high-level restriction, the continued evolution of this form of regulation has made this argument less and less valid today. The draft Determination contains details not only on the price level which DAA is allowed to charge to, but also on very specific blanket levels of service that must be provided to all airline and passenger customers, irrespective of their individual needs and wants.

Perhaps most importantly, the draft Determination effectively vetos investment in significant and crucial pieces of airport infrastructure, which are necessary to both deliver growth and to prepare the business for the market which will be faced in the coming years and decades. While DAA can in theory proceed with the projects, the implicit signal that future price caps will take account of any revenue gains (either directly or via higher growth) but not remunerate the investment costs[2] means that in the majority of cases no commercially oriented business could justify such a risk to shareholders. This detailed shaping of the airport's future infrastructure by the regulator also has implications for the operator's ability to control revenues and operating expenditure.

Irrespective of the wider policy implications of airport competition, the market dynamic today means that an airport's management decisions and behaviour can have a major impact on both the nature and the scale of traffic which is delivered by airlines to that airport. This is particularly the case when an airport is trying to get new routes served, either by existing or prospective airline customers. The right combination of prices and service level will be a key component of this, as will the facilities on offer at the airport in question. Where these are in practice determined by the regulator, it means that the regulator is effectively deciding upon large chunks of that airport's business strategy, and is consequently having a major impact on the future route network and connectivity of that airport, and indeed of the region that the airport is located within. As has been noted in the current process, airlines' traffic projections are directly impacted by the level of airport charges,[3] to say nothing of service quality levels and the actual nature of the infrastructure on offer.

This means that if a regulator decides to use its powers in a manner which involves decision making on a range of issues which are of strategic and operational importance to the airport operator, then it is incumbent upon the regulator to ensure that there is a reasonable degree of commercial acumen reflected in its decision-making process, or at least an understanding of the current and future markets being faced by the airport, and the business strategy necessary to grow within that market.

In an Irish legislative context, CAR cannot be considered to be fulfilling its statutory objective *'to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner'*, if it does not take responsibility for the long-term impact of its final Determination on the overall business of operating Dublin Airport. Regulators which decide to use their powers extensively must also bear the additional responsibility that accompanies this. This is particularly so given that competitor airports in the region such as Shannon and Manchester, and more recently

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[2] See CAR's treatment of revenues from DAA's investment in hanger projects in Para. 5.19 of the draft Determination

[3] '*Maximum Levels of Airport Charges at Dublin Airport – Issues Paper CP2/2013 AER LINGUS RESPONSE*' Aer Lingus, July 2014, p. 6

Gatwick and Stansted have seen a removal or withdrawal of their regulatory frameworks, and subsequently have much greater control over their business strategies compared to Dublin.

While it is obviously open to debate as to how CAR should fulfill its responsibilities, ACI EUROPE considers that the following commercial perspectives are core to the successful running of any enterprise but have not been reflected into the draft Determination. This potentially undermines the ability of DAA to operate Dublin Airport in a truly commercial and competitive manner:

- A holistic understanding of the business as a whole;
- A long-term vision for the business' future;
- A deep understanding as to what is being demanded by the business' key markets;
- A coherent plan to ensure the sustainability of the business via compliance with wider regulatory requirements.

A Holistic Understanding of the Business as a Whole

Larger commercial organisations grapple with the challenge of ensuring that all parts of the business are working in tandem and towards common and mutually beneficial objectives. Typically companies employ sophisticated performance management techniques to avoid situations of '*silo thinking*' or incidences where '*one hand does not know what the other is doing'*, and indeed this is the case at DAA[4]. This is necessary to ensure that the right combination of price and quality are being provided to customers in the most efficient manner possible.

- Security Queue Times

This joined up approach has not been factored into the draft Determination however. In particular the mutual inter-relatedness of security queue times, operating expenditure and investment in facilities does not seem to have been addressed in a level of detail anything close to what would be demanded, were a commercial organization making an equivalent business plan in the field.

The redefined measurement of security queueing times, by CAR's own estimate, effectively reduces the permitted queuing time for passengers by 10 minutes. This arguably represents a 33% increase in the minimum level of service which DAA must provide. Yet there is no indication that this has been factored into the financial model accompanying the draft Determination, the Steer Davies Gleave (SGD) estimates nor indeed Section 4 concerning Operating Expenditure. And while SDG has identified potential efficiency gains in security staffing (despite finding Dublin Airport to be in line with European benchmarks) these efficiencies were explicitly factored in to reduce allowed operating expenditure in this area – not to achieve a higher level of service.

Similarly DAA has advised in its Capital Investments Programme document (CIP) that the current passenger screening area in T1 has sufficient capacity only until 2016. Yet its proposed project to expand the security screening area was not allowed into the price cap. Nor does it permit DAA's

[4] DAA's activities will be cited in a forthcoming ACI EUROPE analysis paper on performance management at European airports.

proposed investment to counter the impact on queue times of new security requirements and technologies which are anticipated in the forthcoming 5 years.

- Passenger Satisfaction

Similarly, CAR has increased the minimum level of passenger satisfaction scores required in a range of ACI survey fields. Again there is no suggestion that potential operating cost implications have been considered. Beyond this DAA proposals to invest to improve levels of service quality, such as 'T1 Check In & Security', 'T1 Arrivals' or the 'T1 Façade' project were not allowed into the price cap. So existing levels of service will have to be maintained despite an annual cut in operating expenditure of almost 2% and in part within an aging facility where passenger satisfaction would naturally expect to be adversely effected.

The above are examples of incidences where the impact on the business as a whole has not been considered. Individual decisions concerning service levels, operating expenditure, capital expenditure and commercial revenues are taken without a full consideration of the mutual interdependence of these different revenue and cost items. Were an equivalent internal project proposal made within a commercial organization, which did not properly capture the impact on the business as a whole, it would be rejected out of hand.

If key business decisions within a company are not aligned then desktop projections of future FFO:Debt ratios will be irrelevant to that company's financeability. Objectives cannot be properly reached in the absence of a coherent and joined-up business strategy.

A Long-Term Vision for the Business' Future

All businesses must plan for the future if they are to grow, and airports if anything exemplify this. Facilities which take time to deliver must be put in place to cater for demand which can materialize much more rapidly. While in previous years it may have been acceptable to deliver infrastructure long after demand initially began to manifest itself, in today's environment airports are obliged to provide the right product at the right time. Airlines are increasingly cautious as to how they deploy their limited aircraft capacity, and will not be obliged to start a new service at an airport that is lacking the appropriate infrastructure. And in the intervening period while the proper facilities are added, aircraft capacity will be deployed to other airports, with these new routes having the time to build up in terms of passenger numbers and profitability. Lacking the right infrastructure can therefore lead to major long-term lost opportunities for airports.

No successful commercial organization will prepare for tomorrow based exclusively on today's demands from existing customers. Yet in essence this is essentially what is mandated when a regulator takes a hands on approach to an airport's capital investment plans. User consultation has its place but the shortcomings of an over-reliance upon this approach are well documented:

- Different airlines want different things. If this reality is not faced up to only the lowest common denominator of necessary capital investment will be allowed, which is not in the longer-term interest of passengers;
- Capital expenditure consultation takes place within a wider regulatory context, with parties incentivized to game the system. Alongside an incentive to veto all but a handful of small capital expenditure, incumbent airlines are also handed the opportunity to shape the airport infrastructure to meet their own needs, and not the needs of prospective new entrant

airlines. This allows them to protect their market position, and is not in the longer-term interests of passengers;

- Airlines have a far more flexible and short-term business perspective than airports, and do not have the same need for longer-term planning which airports depend upon. Again, this means that the longer-term interests of passengers are not protected.

All investment involves risk. That is why it is rewarded. The company which does not understand this, and which only delivers the product that is demanded today, cannot and should not prosper.

DAA have proposed a range of capital expenditure projects designed to facilitate and encourage increased growth, which have been disallowed by CAR. These include:

- Pier 3 Flexibility
- Airfield Infrastructure for Large Aircraft
- T2 Transfer Facility
- Apron 300R
- Line Up Points to R10-28
- Extension to Runway

In addition, a new, later trigger point has been declared for the parallel runway project, meaning that its ultimate delivery will be delayed, thus consequently delaying Dublin Airport's ability to serve certain destinations.

The danger here is that CAR's position that there is no demand for these facilities will become a self-fulfilling prophesy, with no new airlines interested in serving an airport which lags behind its peers in terms of appropriate infrastructure. This may well suit the interests of incumbent airlines who can safely maintain their existing operations (particularly within slot coordinated airports) but it will do nothing for the passengers that will be denied new destinations and choice between directly competing airlines.

The nature of Business Development projects is that they concern business which is not currently in existence. No commercial organization would let their business be dictated by short-term demand. If CAR is determined to exercise its powers in such a way that it becomes part of the airport management's decision making process, then it cannot afford to do so either.

A Deep Understanding as to What is Being Demanded by the Business' Key Markets

All good customer-oriented businesses have a deep understanding of what the market demands, and what they are obliged to provide to their clients to remain competitive. In an airport context, this involves providing the right level of service at the right price to both passengers and airlines, either at an aggregate level or on a differentiated basis if and where this is possible. Airport operators do this by continuous research and ongoing interaction with customers, to best understand what is required of them.

- Service Quality

CAR has decided to hike the minimum levels of satisfaction for all ACI survey targets. Yet a review of responses to the Issues Paper gives no indication that this was actually desired by users. Of the 2 responses which could be said to represent Dublin Airport users (those of Aer Lingus and IATA) both parties expressly warned that overly-high targets should not be set. This warning came because both parties, either as a commercial entity or a representative of commercial entities, intimately understand the relationship between level of service and associated cost (and subsequently price levels). Neither has ACI EUROPE found any evidence that there has been a call from any representative group of passengers for these higher levels of service with their cost implications.

This might at first inspection appear an abstract concern, given DAA's commitment to continuous improvement in its service quality scores, but it does raise some fundamental questions. Dublin Airport ACI Airport Service Quality (ASQ) scores are already strong relative to its peers. If CAR is essentially mandating that Dublin Airport is to be a top-class airport in Europe, then this should be based on at least some evidence that this is indeed what the market wants. While DAA has been improving scores consistently in recent years (albeit from a low base) this is in response to current prevailing market demand. Research may subsequently show that aggregate demand (or the demand of subgroups of the market) is best met by an alternate combination of price and quality. While DAA is theoretically free to drop prices, its inability to drop service quality will constrain this freedom in practice.

A good example of this is Aer Lingus' suggestion that it may be more appropriate to supply wifi at Dublin Airport on a commercial basis[5]. The introduction of free wifi – specifically explained by CAR as being a response to the introduction of its service quality regime- may not have actually concurred with a competitively-derived outcome. It may well have been that all passengers did not want to subsidise the costs of a free service which is used by only a subset of passengers. If this is the case then regulatory intervention may have produced a sub-optimal, albeit populist outcome. Indeed it was warned at the time that 'communications/telecommunications/e-facilities' covered commercial activities which DAA was already incentivized to provide at optimal price and quality levels[6].

A coherent plan to ensure the sustainability of the business via compliance with wider regulatory requirements

While businesses are primarily focused on growth and margins, this cannot be achieved if there is not compliance with minimum legal and regulatory requirements. In the highly-regulated aviation sector, this is all the more so. Business plans which neglect these requirements will not be considered viable due to inadequate considerations of the sustainability of the proposals. Nor will financial projections such as FFO:Debt ratios be considered credible, as they will not factor in the associated risk facing the business[7]. Yet the draft Determination's financial projections are seemingly based upon an implicit assumption that minimum compliance may not be met.

- Security

DAA proposed in its CIP a project to upgrade the Hold Baggage Screening system to remain compliant with EU Regulation Regulation No 185/2010 and amending Regulation No 1087/2011. CAR has disallowed this project on the grounds that '*should DAA find itself in a situation where an upgrade is mandatory, we would expect users to be receptive to supporting additional spend on this item*'. Approval of projects which are to ensure regulatory compliance should not be dependent

[5] 'Maximum Levels of Airport Charges at Dublin Airport – Issues Paper CP2/2013 AER LINGUS RESPONSE' Aer Lingus, July 2014, p. 20-21

[6] '*DAA Response to CP3/2009 Maximum Level of Airport Charges at Dublin Airport Draft Determination Supporting Document I: Summary of Key Concerns'*, DAA, August 2009, p.2

[7] An example of this would be the extra 50 staff which had to be hired following the incomplete compliance with EU Audit Article 15 in March 2012

upon airport user support. The defining characteristic of a Regulation is that compliance is mandatory, irrespective of whether any market player agrees or disagrees with the regulation in question.

No commercial enterprise would refuse to fund compliance measures, on the grounds that their customers do not agree with the regulation. Contingency in the budget would be made for such necessary investment. In equivalent terms, at an absolute minimum CAR could introduce a trigger, to allow the investment to be made if and when it was confirmed that the current T2 HBS equipment cannot be maintained in use until 2022.

- Labour law

CAR's allowed operating expenditure is the mid-point between the high and low operating cost forecasts calculated by its consultants Steer Davies Gleave (SDG). ACI EUROPE understands that the low operating cost forecasts assume a significant level of outsourcing of so-called 'legacy staff' which have been in the employment of DAA for an extended period of time. However as SDG has acknowledged in its consideration of 'TUPE' legislation, any lower costs associated with this outsourcing may be neutralized by labour laws which protect worker's rights, or the voluntary payments necessary to avoid worker's exercising their legal rights. While operating efficiency is an important objective of any company, this must always be done within the confines of applicable legislation. Ethical considerations aside, it would be irresponsible, even for its own financial health, for a commercial enterprise to plan efficiencies on the basis of a credible risk that labour laws will not be respected. Such a company would probably also not rely upon assessments of the legal risks by generalist consultancy firms, but would rather consult a specialised law firm. In equivalent terms CAR should not set operating expenditure targets for DAA which could not be achieved without incurring a risk of operating in a manner which was not consistent with European legislation.

Conclusion

By following a regulatory approach which involves significant decisions on the pricing level, the service quality levels and the nature of future infrastructure at Dublin Airport, CAR is making a major input into the commercial strategy of DAA. To fulfill its statutory obligations CAR must ensure that its decisions allow Dublin Airport to maintain a competitive position against other airports which may have a lower level of regulatory intervention. This is particularly so concerning the ability of DAA to grow both the volume and diversity of traffic at the airport, where competition is most intense. Having a modern fit-for-purpose infrastructure with spare capacity to sell is a core component of this. When assessing the financeability of a company, simply performing a desk exercise which charts FFO:Debt ratios will not suffice, particularly if the assumptions which underlie the forecasts are not the result of a joined-up, commercially oriented and informed assessment of what the business needs to survive and prosper, now and into the future.

It must also be remembered that it is not just the financeability of DAA which is at stake, but the competitiveness and economic vitality of the wider region and nation which Dublin Airport serves. The Irish Department of Transport understands the nature of market pressures upon European airports, and has noted that "*The fortunes of airports and the wider economies they operate within are inherently linked…. Beyond the objective of seeking aggregate growth rates, airports are incentivized to seek out high-value traffic, which opens up new destinations and increased connectivity to a region or country. In particular, new long-haul services are particularly valued by* *airport authorities and the society they serve as they open up new tourism and trade opportunities while increasing aeronautical revenues and airport retail opportunities.*

Unlike other aviation stakeholders, airports generally cannot reduce or change capacity during difficult times. As businesses that incur significant sunk costs in terms of infrastructure investment, airports by necessity must focus on the longer term. Their optimal strategy therefore is to make long-term commitments to the regions and countries they serve and to work towards outcomes that strengthen the economic potential of these areas"[8].

ACI EUROPE therefore requests that CAR consider in detail the impact of its draft Determination upon the commercial business of Dublin Airport as a whole. Addressing the issues referenced above should allow a final Determination which will help empower DAA to operate Dublin in a coherent, forward-looking and competitive manner, while still protecting the interests of both current and prospective airport users, but also ensuring that the maximum possible benefits of future air connectivity are enjoyed by the Irish population and economy.

[8] '*A National Aviation Policy for Ireland – Draft'*, Department of Transport, Tourism & Sport, May 2014, p. 21