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Commission for Aviation Regulation
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By email

Re: Ryanair Submission on COVID-19 Price Regulation Response on Airport Charges at Dublin Airport - CP3/2020

Dear Sir/Madam,

Please find below Ryanair's response to the above consultation paper.

At the outset, it is important to state categorically that Ryanair would be opposed to any outcome from a review that resulted in airport charges at Dublin Airport rising in the short to medium term whilst recovery from the COVID-19 downturn in traffic is ongoing. Given that most commentators expect this to take 3-5 years, this would encompass the entirety of this regulatory period. This should not be taken to mean that Ryanair believes that simply deferring any price rises to the next quinquennium would be the right outcome either.

Dublin Airport losses attributable to the COVID-19 crisis and any associated liquidity concerns of daa should properly be covered by the Irish State through State aid. The COVID-19 Temporary Framework for State aid measures[1] provides numerous ways in which daa could be supported, without the need to revert to a wide-ranging interim review. There is recent precedent that the Irish government and daa can refer to in the European Commission decision of 11 August 2020 in SA.57644 (2020/N) – Germany - COVID-19: Airport Scheme. German airports are eligible to receive compensation for their COVID-19 related losses and liquidity support in the form of grants, guarantees on loans, subsidised interest rates and deferrals of certain taxes and charges. The German example should be followed in Ireland to ensure a stable and viable daa, and adherence to the price cap set out in the 2019 price cap determination (the "Determination") (as amended resulting from the Appeals Panel decision of earlier this year). Hence, a re-opening of the price cap should not be the first response to

[1] Communication from the Commission - Temporary framework for State aid measures to support the economy in the current COVID-19 outbreak, OJ C 91I, 20.3.2020, p. 1, as amended by Communication from the Commission C(2020) 2215 final of 3 April 2020 on the Amendment of the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, OJ C 112I , 4.4.2020, p. 1,by Communication from the Commission C(2020) 3156 final of 8 May 2020 on the Amendment of the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, OJ C 164, 13.5.2020, p. 3 and by Communication from the Commission C(2020) 4509 final of 29 June 2020 on the Third Amendment of the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, OJ C 218, 2.7.2020, p. 3.

the COVID-19 crisis and an interim review held only to address outstanding issues such as rephasing of capex and triggers.

If an interim review is undertaken, the current circumstances would strongly suggest that CAR should adopt a different approach from the conventional 'building blocks' formula, rather basing its consideration on what would be an efficient and competitive response to the crisis in terms of the price charged to users applicable to the remainder of this quinquennium. This should take into account the need to reduce charges and other costs to the industry so as to stimulate recovery in demand for air transport that is so vital to the national economic recovery and which is a key tenet of Irish aviation policy.

Consultation Questions

1. *Does the current situation resulting from COVID-19 represent substantial grounds to review the 2019 Determination?*

In normal circumstances, the shortfall in traffic seen at Dublin Airport would, prima facie, appear to provide sufficient grounds for an interim review of the Determination. However, these are not normal circumstances, with the effects of the global pandemic having widespread implications throughout the entire economy.

We would be particularly concerned if a review was motivated primarily in terms of being the means of ensuring the financial viability of Dublin Airport in the current circumstances. This would effectively represent a transfer of the risks arising from the pandemic from the State, as owner of daa, to users of the Airport. This would be wholly unreasonable. Issues related to the impact of COVID-19 on the viability of the Airport are public health measures that are properly the responsibility of the State, as set out above and not least as it owns daa, and not matters that it is reasonable to expect users to pay for.

The first response to any financial viability concerns of daa should be the State and should not automatically trigger a review of the Determination. We refer to our comments in the introduction regarding the availability of State aid for Dublin Airport, which would enable daa to maintain some level of competitiveness within the boundaries of the price cap in the Determination. Hence, Ryanair starts from the position that an Interim Review is not, prima facie, required at this time (Option 1), unless it is to adjust downwards the price cap to reflect broader market conditions.

That said, Ryanair recognises that some technical adjustments to elements of the Determination could be required to ensure compliance, such as adjustment to the re-profiling triggers to remove elements of the price cap related to capex works that will inevitably be deferred. Hence, this might suggest that there could be grounds for a narrow, targeted review.

2. *Is a narrow, targeted review in 2020 required to address some immediate unintended consequences of the pandemic as discussed in Section 3 Option 2?*
    a. *What is an appropriate timeline for such a review? Our current thinking would be to complete it by the end of 2020.*
    b. *What elements should it address?*

CAR's CP3 document identifies some elements of the price cap that CAR considers would need to be reviewed at para. 3.11, in particular the overall scale of the CIP related to the requirements occasioned by lower passenger demand.

We would also accept that it would be legitimate to continue suspension of service quality penalties, at least whilst social distancing measures remain in force at airports.

CAR, at para. 3.12, identifies the specific elements that it considers could form part of Option 2 – Targeted Interim Review, namely:

- Treatment of T2 Box 2 costs
- Commercial Revenue rolling schemes
- Potential over-collection in 2020 (yield concentration)

We set out our position below in relation to the first two of these issues as part of the considerations that CAR should have regard to if it embarks on a mid-term review.

In relation to the third of these issues, we consider that the only fair and reasonable response in the current circumstances is for daa to adjust its prices so as not to over-collect, which CAR accepts at para. 3.14 is the response that would be expected of an airport operator behaving competitively in order to stimulate recovery in demand.

If a narrow interim review is to be conducted, Ryanair believes it would be advantageous for this to be undertaken speedily in time to reset charges downwards for 2021.

3. Is a more wide-ranging interim review required which would redetermine the regulatory settlement for the later years of the determination? See Section 3 Option 3. What are the key developments over the coming months which might indicate whether such a review is required?

We are not in favour of a wide ranging review at the current time, particularly if a mechanistic approach to the building blocks is proposed, resulting in a perverse pricing outcome of charges rising at a time when the priority should be to provide a demand and economic stimulus. The timescale for any fundamental review should be when the market has recovered to historic levels and the growth trajectory is clearer, which is likely to be around the end of the current quinquennium based on most industry commentators.

The timescale set out for a review in Table 3.1 and the questions posed in CP3 appear to presume that the price cap would continue to be set by reference to a building blocks approach. Ryanair considers this to be a flawed assumption for the reasons already set out and expanded on in response to Question 4. A market price based approach would also enable a review to be completed speedily. If a building blocks approach is taken, it should not lead to a perverse outcome of a non-competitive price cap based on a formulaic approach. There must be an adjustment or other mechanism for a market price to be achieved.

We note that CAR believes that a combination of its Options 2 and 3 would be required but we are unclear what this means in terms of the intentions towards a full review, which would necessarily encompass the elements included in Option 2 in any event, if a building blocks approach continues to be adopted. We could support a hybrid approach if it is based on market pricing, with tidying up technical amendments to the price cap formulation.

Without prejudice to our overarching position (i.e., that an interim review is not required and State aid should be given to Dublin airport to cover COVID-19 losses and address liquidity concerns), we set out below some key considerations in relation to the individual building blocks and the questions posed by CAR.

a. If deemed required, what are the key reasons, for example:

i. Are the risk allocations within the 2019 Determination insufficient to deal with the impact of the collapse of traffic due to COVID-19? See Section 4.

ii. Should the passenger target be revisited? See Section 5.

iii. Should the operating costs and commercial revenue targets be reassessed? See Sections 6 and 7.

iv. Should the cost of capital be reassessed? See Section 8.

v. Is a reassessment of the capital investment plan for the current period required? See Section 9.

vi. How should we assess financial viability? See Section 10.

vii. Should we amend the quality of service regime? See Section 11.

b. What would be an appropriate timeline for this review (considering it may require significant resources on the part of all stakeholders). Our current thinking is that such a review would be complete by the end of 2021 and would take effect from 2022.

c. Should consideration be given to a revised period for the determination (e.g. ending in 2023)?

Risk

We note that CAR concedes (para. 4.1) that the normal regulatory outcome is that, whilst daa holds the risk within the quinquennium, the risk effectively transfers to users at the end of the quinquennium. In these circumstances, it is vitally important then that the regulator can distinguish underperformance due to uncontrollable risks from the circumstances where the regulated entity could have managed the impacts better. There is a perversity in the existing structure whereby, if daa outperforms through lower operating costs or higher commercial revenues, it gets to keep the gain; a situation perpetuated by rolling incentives applied in the last quinquennium, but if it underperforms, e.g. in relation to not meeting opex cost targets, precedent would suggest that the impact of this underperformance gets passed to users at the start of the next quinquennium. The allocation of risk, as applied currently, is therefore not balanced. daa gets to keep upsides within the quinquennium and beyond but any downside risks are passed to users at the start of the quinquennium, the only exception to this being the benefit of higher than expected passenger growth over the last quinquennium which was effectively reset within the most recent Determination.

In the current circumstances, we consider that rather than focussing on risk, a review, if undertaken, should focus on ensuring that the elements of the price cap are efficient for the level of traffic projected. To that end, we concur that the development of agreed scenarios would be appropriate. These scenarios should be on the basis not only of agreement between daa and users to the level of passenger demand under each scenario but also to the appropriateness of the building blocks that go with that. Clear involvement and agreement by users would mitigate the risk of any unfairness in the transfer of risk by avoiding, for example, daa seeking to transfer risk to users for ongoing failures to address excessive operating costs.

Demand Forecasts

We accept the high level of uncertainty in the immediate term in relation to passenger demand forecasts for any airport, not least given the evolving nature of health related restrictions and the deterrent effect to travel. In the medium term, within the quinquennium, Ryanair would expect demand growth to be more responsive to underlying economic recovery. Provided airport charges at Dublin are at competitive levels, we would expect its traffic recovery to be somewhat faster than other airlines operating with a higher cost base and/or to non-European markets.

However, as we have noted in previous submissions to CAR, a simple GDP based forecasting approach fails to recognise that cost is another important variable (see paras. 3.2-3.8 of our response to the Draft Determination CP3/2019). We consider that it will be important to consider the level of airport charges as part of determining traffic recovery scenarios. Recovery will be faster if charges are lower and slower if the converse. This is an important factor which could, if wrongly judged, lead to transfer of risk to users, i.e. underperformance deriving directly from the price cap being set too high.

Opex

At the outset, we note that daa is taking steps to reduce its cost base as a consequence of the pandemic. From public statements[2], it would appear that these steps may, at long last seek to address some of the high legacy costs that have infected the scope for CAR to secure truly efficient operating costs. Hence, there is an opportunity presented by daa's cost cutting actions to thoroughly review cost efficiency from a fresh baseline

In the current circumstances, CAR needs to increase its level of scrutiny to ensure that daa has responded efficiently and effectively in terms of opex, particularly in terms of the extent to which it has used the opportunity, as other organisations are doing, to address legacy contracts and the associated Voluntary Severance Scheme (VSS), as well as the efficiency of security staff, and central staff costs. CAR notes, at para. 6.7 of CP3, that the new VSS is somewhat broader than that envisaged within the Determination. This should be used to set a new lower baseline for the assessment of efficient opex requirements.

Furthermore, any opex cost increases driven by the originally proposed expansion programme should be stripped out and other areas of proposed cost increase, e.g. associated with commercial projects, carefully examined. Any changes to the regulatory process must maintain a focus on efficiency relative to any given level of traffic and ensure that there is transparency, enabling users to comment meaningfully on future opex requirements and costs.

Although recognising the operational challenges that airports face whilst social distancing and other measures are in place, CAR should be careful not to assume that any measures associated with the response to the pandemic can automatically be subject to cost pass through. This would cut across the overarching need to ensure that charges to users are competitive and stimulate traffic recovery. These are public health measures more appropriately covered by the State as discussed above.

Commercial Revenues

With regard to commercial revenues, there is obviously a high degree of uncertainty as to how and to what extent these might recover. CAR should continue to have regard to the interaction between commercial revenues and other building blocks in any review. We have always opposed the rolling incentive scheme in this regard as it has allowed daa to retain the benefit of out performance whereas underperformance relative to opex is passed to users at the end of each quinquennium. In circumstances where daa operates a substantial proportion of the commercial activity itself, this creates a perverse incentive to increase opex in commercial areas to drive revenue growth, the benefits of which daa retains.

Given the extent to which daa directly operates the commercial outlets this better enables it to deliver against targets than would be the case if the majority of activity is outsourced as is normal practice at major airports. Whilst commercial revenue generation may be different in a post-COVID world, e.g. more car parking demand as public transport is used less, sale of

[2] https://www.dublinairport.com/latest-news/2020/06/05/covid-19-costs-daa-160m-in-lost-turnover

health related products etc, it should not necessarily justify a requirement to reduce target commercial revenues per passenger overall.

Cost of Capital

As noted earlier in this response, we would be concerned if the focus of CAR in any interim review was too heavily focussed on financeability (see below). As made clear, we believe that the focus of any interim review should be on delivering a price that incentivises growth. Hence, a mechanistic approach to cost of capital could be counterproductive.

That said, it is relevant that Equity Returns are materially lower in the current circumstances than CAR's estimates and there are clearly wider short to medium term pressures to keep the cost of debt low. Hence, it is reasonable to expect that the Cost of Capital, if estimated today, would be below that used in the Determination, even before consideration of the scale of the capital programme and any financeability adjustment.

We believe the ability to have a further mid-term review (on the cost of capital and financeability adjustment, as advised by the financial advisors) would be sufficient in itself without the need to incorporate flexibility measures to address uncertainty. However, there is a strong case for stripping out any aiming up adjustment driven by the large planned capital programme in any event.

Capex

As CAR notes, in para 9.6 of CP3, most capital investment at Dublin Airport has ceased and the scale of capital programme aimed at delivering capacity for 40 mppa shortly after 2024 is no longer relevant. Most forecasters expect a 4-5 year lag before airports reach pre-COVID passenger levels, which strongly suggests that almost all of the capital programme could be deferred. We have always taken the view that this capital programme was over-scoped and elements of it were premature in any event. In the current circumstances, Ryanair considers that all of the projects subject to reprofiling triggers can be deferred to the next quinquennium and the price reduced accordingly.

For the longer term, it is vital that CAR renews and reinvigorates its scrutiny of daa's proposals to ensure that they truly reflect the requirements of users for the efficient operation and development of Dublin Airport. We remain concerned, as stated at the recent Appeal Panel, that CAR has overly prioritised the funding of an unrealistically large capital programme at Dublin Airport over the legitimate interests of users. If there is to be an interim review, establishing a realistic and robust capital programme would need to be at the centre of the exercise, with an emphasis on affordability first and foremost, i.e., looking at the level of capex that can be delivered within a lower price cap rather than looking to ensure a fundable capital programme at whatever cost to users. In the circumstances of recovery from COVID-19, there can be no legitimate justification for continuing with the scale of capital investment originally proposed within any foreseeable timeframe. To do so would simply represent an unfair transfer of risk to users.

CAR needs to avoid the perverse incentive, noted at para 9.7 of CP3, that daa is incentivised to proceed with unnecessary capital projects simply to avoid clawback in the next quinquennium. The opportunity should be taken, if an interim review proceeds, for a collaborative review of the capital developments required in a post-COVID environment where investment priorities should have changed with a greater emphasis on cost-efficiency and prudence. This would provide an opportunity to re-constitute re-profiling triggers going forward to better reflect potential growth scenarios and to re-set the StageGate process to consider the timing and scope of requirement as well as simply the cost.

We believe that it would be fair to users to withdraw the T2 Box 2 remuneration as the threshold has not been reached. However, before reaching a definitive conclusion on this, the price cap effect in future quinquennia would need to be understood given the approach taken of ensuring that any adjustments to the Box 2 allowance are overall NPV neutral to daa.

<u>Financeability</u>

At the outset, we reiterate that we do not support the advancement of depreciation in order to enhance the financeability of the excessively large capital programme at Dublin Airport. In the reasonable expectation that this capital expenditure will be in large part deferred to the next quinquennium, we believe strongly that, in any building blocks based interim review, the financeability adjustment must be stripped out.

In any event, given ongoing State ownership of daa, we continue to believe that daa will find it easier to raise debt than other airports operating in higher risk environments and under wholly private sector ownership. We believe that this places daa in a strong position going forward where investors will seek more certain investments, provided it can demonstrate that it is operating efficiently. Based on current traffic performance (to the end of May 2020), Dublin Airport has not faced any greater traffic volatility than other airports, such as the major airports in the UK.

Whilst S&P may have downgraded daa's rating, in common with those for other airports, the rating for Ireland has in fact improved. Hence, Dublin Airport effectively has a stronger sovereign support, which is an important aspect from an international investor's perspective.

<u>Quality of Service</u>

As indicated earlier, we accept the suspension of quality of service penalties in the short term. If CAR proceeds with an interim review, it may be appropriate to consider what should be the priority metrics in the medium term.

4. Should the Commission examine new regulatory approaches or methodologies to deal with the exceptional levels of uncertainty resulting from the impact of COVID-19?

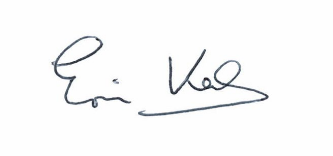
We believe that, at least for the remainder of the current quinquennium, it would be appropriate to move away from a rigid application of the building blocks approach and to adopt more of a market price-based approach. Recognising the difficulty of an approach relying on price benchmarks and comparability, such an approach might adopt different metrics, for example the extent of price reductions being offered in a competitive market against pre-COVID levels. This would need to rely on actual charges levied rather than published tariffs.

Having set a fair competitive price, it would then be for daa to adjust its plans, for both opex and capex, to fit within the price cap set.

Such an approach would help to offset the risks inherent in applying a building blocks approach against a series of passenger growth scenarios without considering the extent to which price would impact on the achievability of each of the scenarios. It is this circularity which contributes materially to risk. Adopting a market pricing approach would mitigate this risk considerably, leaving daa with its own controllable risk of being able to manage within its resources. Any alternative approach would represent an unfair transfer of risk.

If a scenario-based approach is to be adopted, it is essential that this is done collaboratively and holistically to ensure that the linkages between cost and growth are fully reflected. We are ready to participate in such a process in order to reach an outcome that best serves the overall interest of consumers in Ireland to stimulate economic recovery.

Yours sincerely,



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