COMMENTS OF AER LINGUS ON RESPONSES TO COMMISSION PAPER CP7/2004

INTRODUCTION

The Commission for Aviation Regulation (the "Commission") has published the responses it has received to CP7/2004 and has invited comments on the content of these responses. Aer Lingus welcomes the opportunity to review and comment on the other responses.

Aer Lingus has reviewed all of the other responses to CP7/2004. The only response that we have specific comments on is that of Dublin Airport Authority (the "DAA") and the associated report produced by NERA on behalf of the DAA. Our comments on these two papers are set out below.

1. DAA RESPONSE

(a) Financial viability

The DAA comments on page 8 that "[t]hese new [statutory] objectives are in line the guidelines set for economic regulators in the UK, who typically have duties to ensure that firms can finance their regulated activities, …". Aer Lingus agrees with this assessment. However we note that elsewhere in its response, the DAA interprets the statutory objectives in a materially different way to the practice of UK regulators.

In particular, the DAA focuses heavily on the statutory objective to enable the DAA to operate and develop Dublin Airport in a sustainable and financially viable manner. Aer Lingus believes that the DAA's interpretation of this objective is overly prescriptive, and if applied, would be detrimental to the economic regulation of Dublin Airport. As we made clear in our response to CP7, Aer Lingus considers that the Commission's duty under this section is fulfilled if, on a forward looking basis, landing charges are set to provide an efficiently run DAA with a return on its investment equal to its weighted average cost of capital. This approach will, in itself, be sufficient to ensure that the business maintains adequate financial ratios provided that the financing arrangements are reasonably efficient.

The experience of the utility regulators in the UK shows that the regulators do typically undertake financial ratio analysis of regulatory proposals to ensure that financial ratios over the period are satisfactory, even though their statutory objectives do not necessarily require such analysis to be undertaken. Aer Lingus accepts that financial ratio modelling can serve as a useful crosscheck to the assessment of the proposed price control. We also acknowledge that there are circumstances where financial ratios can fall below the appropriate level even though the cost of capital is adequate without this implying inefficiency on the part of the regulated company. Typically this has occurred when the regulated business faces a substantial investment programme to be undertaken over a short period of time. It should be noted though that these situations will only be temporary.

It is important to understand that the UK regulators have used financial ratio modelling in the manner described above, not as a method for compensating companies for their actual capital structures. For instance:

- Ofwat's financial ratio modelling is not based on the company's actual level of gearing. Rather it is based on Ofwat's assessment of the *appropriate* level of gearing start of the price control period. This aspect of Ofwat's approach was not made clear in the NERA paper's description.
- Ofgem / OFFER have addressed temporary periods of financial constraints by tilting the depreciation profile to increase cashflows during that period.

Both of these approaches are intended to be neutral in present value terms, i.e. customers do not end-up paying more as a result of this temporary situation in NPV terms.

Overall, the experience of the UK regulators is consistent with our assessment of the role of financial viability in setting regulated prices.

(b) Balancing objectives

The DAA states that "[w]here there is a required trade-off between conflicting statutory objectives, the financial viability of the regulated company should be regarded as the pre-eminent objective" (p10 of response). Aer Lingus notes that the 2004 Act does not give precedence to one statutory objective over any other. We do not accept therefore that the DAA's interpretation of the 2004 Act is correct. Furthermore, we do not believe that the statement by the Minister for Transport, quoted by the DAA, gives precedence to financial viability over the other objectives.

The Commission has been issued with three objectives under the 2004 Act. It is clear that the Commission’s duty is to attempt to meet *all* of these simultaneously. It is, however, in the nature of multiple objectives that there may be times when it is not possible to achieve all three objectives equally. In such circumstances it is appropriate for the Commission to make best endeavours to achieve all three objectives and to use its judgement where trade offs need to occur, in particular balancing the interests of customers and shareholders. The DAA's interpretation of the objectives would suggest that the interests of shareholders are paramount. We note, however, that in a competitive market (the outcome of which the regulation of Dublin Airport is attempting to replicate), the only protection afforded to shareholders is by their firm remaining competitive in cost terms.

The example cited by the DAA in support of this argument, the relaxation of the price cap for NATS by the CAA in the UK, relates the regulatory response to a significant unforeseen circumstance arising during the course of a price control period. Regulators across all utilities will have methodologies for dealing with unforeseen events. We do not consider that such examples are relevant for assessing how a regulator should approach a price control and, in particular, for the treatment of inefficient costs.

(c) Cost competitiveness

The DAA states that "[t]he new emphasis is on a requirement to have regard to the cost competitiveness of airport services at Dublin Airport. This allows for an examination of the relative competitiveness of outputs produced by the airport." The DAA appears to be interpreting the statutory factor as referring to the price competitiveness of Dublin Airport. This interpretation is unwarranted. The statutory factor specifically refers to "cost competitiveness" and does not mention price competitiveness.

We remain of the view, expressed in the response to CP7/2004, that the changes introduced by the 2004 Act do not require the Commission to alter its approach to benchmarking.

2. NERA REPORT ON DOTECON PAPER

NERA's review of the DotEcon paper is detailed and we believe that much of their analysis is based on misunderstanding or a wilful misinterpretation of DotEcon's paper. The core issue is the regulatory treatment of inefficient costs. The DotEcon paper argues that the disallowance of inefficient costs from the price control calculation is consistent with economic efficiency. The NERA paper argues that the disallowance of inefficient costs could run counter to economic efficiency and is against accepted regulatory practice.

We believe that setting regulated prices on the basis of an assessment of the efficient level of costs *is* consistent with promoting allocative, productive and dynamic efficiency. With regard to NERA's arguments we would make three observations.

First, NERA identify potential downsides, in terms of the reaction of investors, to inefficient costs being disallowed. Our view is that these downside effects would only occur if the regulator's approach to disallowing costs was arbitrary or unpredictable. If the assessment of efficient costs follows a transparent and consistent methodology then the impact should be minimal.

Second, NERA claim that regulatory practice is to allow a company's actual costs combined with an annual efficiency target. While this is an accurate description of most UK regulatory experience, it ignores the fact that the efficiency target is set to ensure that the company converges to the efficient level of costs. Regulators allow convergence to the efficient level of costs to reflect the fact that inefficiencies may take some time to remove. It also takes account of the fact that there will always be some uncertainty regarding the efficient level of costs. Convergence therefore reflects a prudent approach by the regulator. This practice of converging to the efficient level of costs is consistent with the theoretical conclusions made by DotEcon.

Third, NERA is being disingenuous to claim that setting prices on the basis of efficient costs "violates the requirements of allocative efficiency". On the contrary, setting prices based on efficient costs is essential for promoting allocative efficiency in the long-run. In a competitive market prices are set by the costs of the efficient firms, not the inefficient ones. Inefficient firms make losses and are forced to reduce their costs or leave the market to more efficient competitors.

On the basis of their analysis, NERA concludes that the rate of return for the DAA should be set on the basis of the actual cost of capital, rather than the efficient cost of capital. Aer Lingus does not accept this conclusion. Setting prices on the basis of the efficient cost of capital for DAA is consistent with the Commission's statutory objectives and will promote economic efficiency. It is possible that the actual cost of capital at the start of the regulatory period will be above the efficient level because the DAA's level of gearing is above the optimal level. In this case, it would be appropriate for the Commission to consider how easily and how quickly the DAA could move to the optimal level of gearing and whether, during the period of transition, the regulated business maintains its financial viability. However, it is not necessary for the Commission to use the actual cost of capital to set the rate of return for the whole of the price control period.