Aer Lingus Submissions on Commission Paper CP7/2004

1. GENERAL COMMENT

With the exception of the new section 33(2)(f), which requires the Commission to have due regard to certain policy statements, Aer Lingus views the changes to the Aviation Regulation Act 2001 (the "2001 Act") imposed by the State Airports Act (the "2004 Act") to be either changes in emphasis (i.e. the promotion of certain considerations from being factors that the Commission should "pay due regard to" into statutory objectives) or refinements of wording that, arguably, place less prescriptive requirements on the Commission or increase the flexibility with which it can approach its task of regulating Dublin Airport in an effective manner. Hence, in our view, the 2004 Act should not require the Commission to alter its approach to regulating airport charges to any significant degree.

In particular, the Commission should still seek to set airport charges for Dublin Airport in such a way that charges reflect costs efficiently incurred on behalf of the users of Dublin Airport and so that Dublin Airport is encouraged to maintain an efficient approach to investment and operation over the long-term.

The issues raised by each individual question in CP7 are discussed further below.

2. STATUTORY OBJECTIVES (Section 33(1) of the 2004 Act)

Aer Lingus believes that the Commission correctly interpreted the primary statutory objective of the 2001 Act by stating that the regulatory approach should be geared to achieving productive, dynamic and allocative efficiency. We believe that determining airport charges that seek to maximise these efficiencies remains the best way for the Commission to meet the revised statutory objectives.

Section 33(1)(a) now requires the Commission to "facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and prospective users of Dublin Airport". We believe that the term "efficient and economic" should be interpreted in exactly the way that the Commission interpreted "cost effective" under the 2001 Act. Hence "efficient and economic development" should be equated to the achievement of dynamic efficiency and "efficient and economic operation" should be equated with productive efficiency.

Section 33(1)(b) requires the Commission to "protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport". We believe the Commission would be correct to interpret "reasonable interests" in the same way as it previously interpreted "meeting the requirements of users", that is by regard to allocative efficiency, where all

users willing to pay the efficient cost of a service have access to it (or can be expected to have in the future).

Section 33(1)(c) requires the Commission to "to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner". The Commission identifies this as an entirely new provision. In our view, while it is clearly a new statutory objective, the provision is not itself entirely new, as it replaces 33(b) of the 2001 Act, which stated that the Commission should have due regard to "a reasonable rate of return on capital employed in that investment, in the context of the sustainable and profitable operation of the airport". Clearly to achieve productive and dynamic efficiency, prices must be set so that the operator of Dublin Airport is financially viable provided costs are efficiently incurred.

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 the Dublin Airport Authority with a return on its investment equal to its weighted average cost of capital. However, for this obligation to be consistent with the other statutory objectives, it is sufficient for the Commission to allow for this return on capital on a strictly forward-looking basis: that is prices should be set using reasonable assumptions regarding the years covered by the determination so that the Authority would be expected to earn a reasonable return on its investment. This will ensure the financial viability of the Authority. The Commission should not seek to ensure that the Authority recovers its weighted cost of capital in each year, as this is not required for the Authority to be financially viable and would be expected to undermine its incentives to achieve and maintain productive and dynamic efficiency. Furthermore, the assumptions underpinning such a projection should only include efficiently incurred costs (past, current and projected). This necessarily includes only prudently incurred financing costs and hence also implies an efficient capital structure. In this way the Commission's actions would be consistent with Sections 33(1)(a) and (b) as well as ensuring financial viability.

The fact that financial viability is recognized as an objective, not simply a factor to be paid due regard, recognizes that the expectation of financial viability subject to efficient performance is an integral part of achieving an efficient regulatory outcome, particularly in terms of dynamic efficiency. The exclusion of references to "a reasonable rate of return on capital employed" means that the Commission should not consider itself obliged to equate actual returns in any one year with the financial viability of the Authority.

3. STATUTORY FACTORS (Section 33(2) of the 2004 Act).

(a) Restructuring

We are unclear as to why this provision does not apply to the first determination made after the Dublin Appointed Day. Presumably there are functions (and associated costs) presently in Dublin that relate to the coordination of the three Aer Rianta airports. It seems entirely reasonable that

these costs should be excluded from any determination for a standalone Dublin Airport. If the issue is that the Commission will not be able to predict the exact date of separation at the time of conducting its first determination then it should nevertheless consider identifying at this stage the relevant costs and including a specific adjustment to Dublin's cost base that can be applied as and when the separation occurs.

(b) The level of investment

Aer Lingus agrees with the approach that the Commission took to calculating Aer Rianta's investment programme in its previous determinations. We do not consider that the changed wording of the 2004 Act requires any change in the approach that the Commission should adopt.

We believe that it is critical that all elements of Dublin's investment proposals be:

- demonstrated to have the support of a significant body of users, sufficient to indicate that such investment would be commercially viable; and
- subjected to appropriate cross-checks and benchmarking as to ensure that the proposed level of costs is efficient.

While recognising the primacy of safety considerations, we nonetheless consider it vital that proposed investment in safety is also subjected to an appropriate level of investigation and challenge.

It is also vital that the Commission then monitors the quantity and quality of actual investment to ensure that investment that has been funded has actually been carried out and to ensure that the Authority cannot earn returns on investments that it does not undertake in practice.

(c) A Reasonable return on capital

For the reasons outlined above, Aer Lingus considers that the omission of an explicit reference to returns on assets does not change the need for the Commission to estimate Dublin Airport's Regulatory Asset Base (RAB) and its cost of capital. These parameters will continue to play a central role in regulation of airport charges, so as to ensure that productive, dynamic and allocative efficiency is achieved.

We add two comments, however: first, it is important that the legal separation of Dublin, Cork and Shannon does not lead to a transfer of value to the airport owners – hence the combined RAB of the three separated airports should not exceed the combined RAB of Aer Rianta prior to the separation. Furthermore, the separation should be conducted to reflect the proportion of operational assets at each of the three airports.

Second, the Commission refers to "the appropriate rate of return on capital employed" as distinct from the cost of capital. In our view the two are not separable. The appropriate *ex ante* target rate of return for a regulated

company is its weighted average cost of capital. Under specified circumstances, as part of a specific efficiency incentive mechanism it may be acceptable to target a slightly higher (or lower) rate of return in the short run. But this must only be as a specific time-limited reward for cost efficiency savings. There is no justification for setting the target rate of return above the cost of capital, either to allow for uncertainty regarding future factors outside the company's control (which should be allowed for in cost and revenue estimates) or to allow the servicing of financing costs for an inefficient capital structure (see comments in (g) below on liabilities).

(d) Efficient and effective use of all resources

While it is true that Section 33(c) of the 2001 Act has been deleted, we believe that this factor is entirely subsumed within the obligation placed on the Commission under Section 33(1)(a), discussed above. We therefore do not believe that the Commission's task should change at all, either with regard to the determination of the currently-efficient level of costs or with regard to setting forward-looking efficiency targets.

(e) Contribution to the region

Aer Lingus agrees that any suggestion that charges at Dublin Airport should cross-subsidise those at Cork and Shannon is contrary to the Commission's statutory objectives, both under the 2001 Act and as amended by the 2004 Act.

We consider that Dublin's charges should be set to reflect costs efficiently incurred in Dublin alone and should, as the 2004 Act now states, reflect the interests of users of the airport itself. For this reason we welcome the deletion from the Act of references to "the contribution to the region". This is not a matter that should enter into the determination of efficient airport charges.

(f) The level of income

Aer Lingus notes that the Commission raises the issue of "single till" versus "dual till" in this context. Aer Lingus considers that the change from the previous Section 33(e) to Section 33(2)(c) does not in any way require the Commission to re-open this matter.

In our view single till remains the most appropriate basis on which to set airport charges. If the matter is debated again during the course of the review we will argue our position forcefully. In our view this is not a matter of the availability of appropriate accounting systems, but rather a matter of economic efficiency.

(g) Costs or liabilities

Aer Lingus notes the inclusion of the term "liabilities" in Section 33(2)(d). We are concerned with the hypothetical interpretation of this new factor put forward in the Commissions' presentation of 1 October. Moreover, it is essential that this provision is not interpreted in a manner whereby prices at Dublin Airport are artificially inflated as a result of the restructuring or by

Dublin Airport entering into commercial arrangements with Cork/Shannon other than on an arm's length basis.

As regards the first point, the Commission's presentation asks whether the new "liabilities factor" should mean that the cost of servicing Dublin Airport Authority's debt should be explicitly added into the regulatory formula as an additional factor. We believe this approach to be wrong: it would double count the cost of Dublin Airport Authority's debt as well as undermining the incentives for Dublin to maintain an efficient capital structure. The value of the capital required to operate Dublin Airport is reflected in the airport's RAB and the cost of maintaining this capital is measured by the weighted average cost of capital. Given this fact, adding the cost of debt financing as an additional factor in the price formula would mean that Dublin Airport would be remunerated twice for its debt. Simply allowing for Dublin to receive the WACC on its RAB is sufficient to ensure that Dublin Airport can finance efficiently incurred liabilities. Allowing any specific factor for the cost of debt on a cost-pass through basis would also encourage Dublin Airport to increase its gearing inefficiently because it would know that any debt financing costs would be included in future price limits.

As regards our second concern, it is our view that in order to meet its statutory objectives the Commission should set prices that cover efficiently incurred operating and capital costs incurred for the benefit of Dublin Airport. Hence it follows that prices at Dublin should not be adjusted to cover the cost of debts not directly associated with efficient investments at Dublin. This would be achieved provided the RAB for Aer Rianta is divided between the separate authorities in the way described previously and prices are determined in Dublin using the same methodology as applied at the previous determinations.

In our view, prices set to encourage productive, dynamic and allocative efficiency must also reflect an efficient capital structure for the regulated enterprise. This is a common assumption applied by regulators in the UK and elsewhere. As a consequence, prices should not be adjusted upwards to allow a regulated enterprise to meet inefficiently incurred financing costs. In the case of Dublin Airport, Aer Lingus is concerned that debts incurred for the development of Cork and Shannon may be transferred to Dublin and that Dublin prices may be increased to finance this debt. This could be achieved either by increasing Dublin's RAB above the level strictly implied by the physical assets used at Dublin, or simply by adjusting Dublin prices to ensure an acceptable interest cover ratio on the adopted debt. Neither approach is consistent with the Commission's objective to facilitate the efficient and economic development and operation of Dublin Airport. Adjusting the RAB would mean that prices at Dublin did not reflect efficiently incurred costs, which fails the test for productive efficiency. Adjusting pricing to allow satisfactory cover ratios over and above the level implied to earn an adequate return on assets means that an inefficient financial structure is being supported. This means prices are excessive (failing the test for productive efficiency) and runs the risk of distorting investment decisions (which distorts dynamic efficiency.

(h) Policy statements

Aer Lingus agrees that Section 33(2)(f) potentially places a very wide-ranging and unpredictable obligation on the Commission. We are concerned at the potential for this clause to be used to undermine the fundamental objectives of price regulation at Dublin Airport. However, we note that this section is one to which the Commission have to pay "due regard". As such, Section 33(1) which sets out the statutory objectives as amended by the 2004 Act, clearly takes precedence. The Commission under the 2004 Act has a statutory objective to facilitate the efficient and economic development and operation of Dublin Airport. This objective cannot be set aside in deference to a policy statement.

(i) Cost competitiveness

Aer Lingus broadly supports the approach that the Commission has taken to benchmarking, factoring the potential for improvement in efficiency into an X-factor in the price cap formula. However, Aer Lingus remains of the view that there is still substantial inefficiency at Dublin Airport. In our view the changes introduced by the 2004 Act do not require the Commission to alter its approach to benchmarking. We appreciate the difficulties in performing international comparisons of airport efficiency. However, the deletion of the reference in the Act to international comparisons does not mean that the Commission cannot or should not use such information. In our view it merely means that the Commission is free to give such information the appropriate weight in a balanced consideration of Dublin Airport's efficiency.

(j) The level and quality of services

We do not believe that the change to this statutory factor under the 2004 Act should change the Commission's approach. The determination of appropriate levels of service is a key part of any determination of landing charges. These levels need to be related to the funding that Dublin Airport receives. Furthermore, the Commission needs to monitor performance against these levels to ensure that the funding Dublin Airport receives is being used in the way anticipated.

(k) Minimum restrictions

Aer Lingus agrees that, as a result of the change to the Act, there is no need for the Commission to change its policies with regard to placing minimum restrictions on Dublin Airport.

(l) Obligations

Aer Lingus considers that the change to the Act does not require the Commission to change its policies with regard to paying due regard to national and international obligations.