DUBLIN AIRPORT
CONSULTATION COMMITTEE

Representing the Needs of Dublin Airport Users

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Response to CP6/2008 – Issues Paper on the Maximum Level of Airport Charges at Dublin Airport

Introduction

The Dublin Airport Capex Consultation Committee (DACC), a body which represents over 90% of Dublin Airport's scheduled airlines, charter airlines, cargo operators and handlers, welcomes this opportunity to comment on the Issues Paper published by the Commission for Aviation Regulation (the Commission) on 24 October 2008.

The DACC deferred the submission of response beyond the original 18th December 2008 deadline, and informed the Commission of its reasons, in the light of the announcement by DAA on that day that it was deferring the construction of the new runway and making other adjustments to its capital and operational costs. The DACC considered it important to seek clarification of DAA's intentions as the announced changes to capital and operational plans are obviously highly material to the issues to be considered in the forthcoming review. DAA has, however, declined to meet with users to discuss these fundamental changes in approach, pending appointment of an independent chair for the meetings as raised in previous correspondence between the DACC and the CAR.

On 23rd December, the decisions of the Aviation Appeal Panel, although relating to the Determination for the period 2006-2009, indicated areas which the Panel considered would fall to be considered in the next review of airport charges for the period 2010-2014[1], which is the subject of the Issues Paper. In the circumstances, the DACC considers that it should not delay its response to the CAR's Issues Paper any longer as there can be no certainty if and when DAA will be willing to meet with users at Dublin Airport. This submission, thus, makes reference to matters arising from the decisions of the Appeal Panel and from DAA's recent announcement which the DACC considers that the CAR should address in this review.

[1] Issues relating to the Review of the 2007 Determination will be dealt with in a separate response to CP1/2009.

We set out our more general comments in relation to each of the chapters of the Issues Paper in the main body of this response and we set out responses to the specific questions raised at the end of each chapter by the Commission in Appendix A of the response. This paper does not set out to repeat material previously submitted to the Commission, although we cross-refer to previous responses made by the DACC to the Commission on specific consultation issues.
Although this paper follows the structure of the Commission's Issues Paper, we wish to highlight an associated issue, which is not directly addressed by the Commission in the Paper, but which runs through each and every other regulatory process, namely the lack of adequate consultation between DAA and its customer airlines and the failure to provide relevant information. The Commission is aware, through previous correspondence on this issue, that this is a fundamental problem faced by users. The problem was recognised by the Commission in CP8/2007 and in CP5/2007 the Commission stated that *"If all users agreed that a proposed investment was necessary, met their needs and the costs were acceptable, the Commission would be minded to incorporate the planned capital expenditure into a determination even if there has been no significant consultation in developing the plan. Conversely, the Commission would not include investment on a project in the RAB that has not yet commenced if users all expressed the view that despite the DAA undertaking an extensive consultation process and reflecting all their suggestions, in the interim the situation had changed such that all users no longer felt the project would meet their needs."* [2] Adhering to these principles would imply not just a willingness to reject new capital projects which do not meet user needs but to revisit issues such as the extent and timing at which costs associated with T2 should enter the RAB.

The DACC still believes that a constructive engagement process between DAA and its users is possible, but is seriously concerned that the process has now been stalled for some three months due to the Commission's failure to appoint an independent chairperson. The DACC takes the view that the Commission needs to be far more closely engaged in support of implementing this process. The failure of the Commission to progress the appointment of an independent chair appears at odds with the offer at paragraph 7.16 of the Issues Paper for the Commission to organise and host a series of meetings to discuss capex at the airport.

The Commission's existing approach was criticised in the recent Appeal Panel decisions where the Panel stated that *"The Panel is of the view that the Commission might well be best advised to carry out that analysis by reference to the competing contentions of the DAA (….) and Ryanair, by way of a joint meeting/hearing with Ryanair's consultants, the DAA's consultant's and by the Commission's own consultants, rather than by way of <u>passive regulation</u>, as appears to have occurred to date."*[3] (emphasis added) This suggests strongly that the Commission should actively engage in ensuring full consultation takes place and to actively participate in discussions to ensure that it is able to make its regulatory decisions on an informed basis.

[2] CP5/2007 paragraph 5.1
[3] Decision on Ryanair's Appeal, paragraph 8.12.

At the outset, the DACC wishes to emphasise that airlines are currently operating in one of the worst economic crises of recent times. We see the role of the Regulator as fundamental in ensuring that the DAA monopoly does not exploit its position to the disadvantage of users in the present economic climate, when airlines at Dublin and elsewhere are having to cut costs further simply to survive. The aviation industry is facing an unprecedented crisis at present, with airlines grounding aircraft, laying off employees, and radically cutting costs. The recently announced Airline Travel Tax will increase the costs of air travel further and act to further suppress demand. As a result, it is the airline users that are currently taking all of the pain, whilst DAA has been talking of raising charges, introducing new charges, and pricing up to the cap. It would be an abdication of the Commission's statutory duty, and simply unacceptable to users, to allow a monopoly provider such as DAA to take this kind of high-handed approach under current circumstances. A principal function of the regulator is to replicate the disciplines which would be imposed on an airport operating in a competitive market, where that airport would be expected to be responsive to the needs of its users, or risk losing them to a competitor. It is therefore imperative that the Commission takes a robust and fully engaged approach in fulfilling its statutory duties and ensuring that users are not disadvantaged by the actions of a monopoly provider by placing firm controls on its behaviour.

The Commission's Approach to Regulation

The DACC notes that the present form of regulation is based on a price cap, expressed as CPI plus or minus X, which is determined by a series of regulatory building blocks set out on the basis of a 'Single Till'. As the Commission acknowledges, a key feature of this form of price cap regulation is the incentives it seeks to create for the monopoly provider to generate efficiencies and lower prices, as would be the case if it were operating in a competitive environment. These incentives are created by allowing DAA to retain any profits it is able to make over and above those assumed in the Regulator's forecasts for the duration of the regulatory period. Conversely, if DAA fails to achieve the performance targeted then it bears the full costs.

However, these incentives can act in perverse ways. For example, under this form of regulation there is also an incentive on the Airport operator to make forecasts of performance which are insufficiently challenging in order to 'game' the regulatory process and retain additional profits during the period rather than passing them on to users in the form of lower airport charges. The problems inherent in RAB based economic regulation were recently highlighted by the UK Competition Commission (CC) in its provisional findings, dated 20 August 2008, in relation to its inquiry into the BAA Airports Market. The CC was highly critical of BAA's lack of responsiveness to the requirements of its customers, the airlines, as evidenced in its approach to planning capital expenditure. The CC also found that there was scope for significant savings in BAA's capital expenditure. It expressed concerns about the lack of constructive engagement and consultation on capital expenditure (e.g. in the context of the overall level of investment to be assumed in the RAB and in setting the level of charges) and significant increases in BAA's projected capital and operating expenditure. These failures in consultation by BAA are mirrored in the current behaviour of DAA.

The CC also recognized that:

"the incentive in regulatory reviews under the RAB system is to increase projections of both capital expenditure and operating expenditure (and to underestimate projected revenues from non-aeronautical charges, and retail and commercial revenues, and thereby increase overall revenue requirements and airport charges). Although we accept that there were some offsetting cost reductions at Heathrow and Gatwick, and that the CAA did not accept all of BAA's proposed increases in costs, the changes to BAA's projections during and after our inquiry had the effect on balance of substantially increasing its overall revenue requirements, giving rise to strong suspicions among the airlines that BAA had 'gamed' the whole process".[4]

The CC concluded that RAB based regulation *"incentivizes BAA to play the regulatory game – invest in order to achieve an allowed return – rather than providing what users necessarily want, in terms of quantity, quality, location and timing of investment."*[5]

This same logic applies equally to DAA as it is an inherent failing in this system of regulation and of monopoly airport providers rather than a specific finding in relation to BAA.

The Competition Commission also called for *"a safeguard provided by the CAA for airlines if unnecessary costs have been included in the RAB, or if alternative inappropriate projects have been undertaken"*.[6] The Competition Commission went on to make a provisional finding that *"the system of regulation is a feature which distorts competition between airlines"*[7] due to failings in relation to investment and quality of service. Specifically, the Competition Commission noted the CAA's failure to ensure an adequate consultation process between BAA and its airline users and, in particular, through:

"(i) Not facilitating the provision by BAA to the airlines and others of adequate information on a timely basis.

(ii) Its reliance on Constructive Engagement but failure to act when it fails……….. This includes its reluctance to assist in the resolution of inevitable difficulties during detailed discussions for fear of crowding out commercial interaction which has led to investment proposals that are not as responsive to the requirements of airport users as might reasonably be expected…………."[8]

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4 UK Competition Commission, BAA Airports Market Investigation, 20 Aug 2008, paragraph 2.40.
5 Ibid, paragraph 7.21.
6 Ibid, Paragraph 2.66.
7 Ibid, Paragraph 7.41.
8 Ibid, Paragraph 7.37.

There are relevant parallels here with the inadequate consultation process between the DAA and its users and the Commission's failure thus far to intervene and ensure that the interests of users are protected.

Although the DACC does not wish to undermine the concept of regulatory incentives per se, we believe that DAA should not automatically be entitled to retain additional profits for the course of a regulatory period in circumstances where it cannot be established that genuine efficiencies have been achieved. DAA should only be entitled to keep additional profits in the course of a regulatory period if the Regulator can determine, in consultation with users, that such additional profits are the result of genuine performance improvements. For example, if efficient operations by airlines and lower fares result in increased passenger numbers, this should not be regarded as an 'efficiency', which DAA can retain the benefit from, but the benefits should be passed back to those airlines, by way of lower airport charges, who have created the demand. This argues for the Regulator to take a very proactive approach in evaluating the efficiencies that DAA should be able to make during the course of a regulatory period and in assessing whether DAA should be rewarded during the course of the period by retaining profits generated over and above agreed forecasts.

In similar fashion, there is also a strong incentive for DAA to inflate its planned capital investment programme on the basis that it can recover a return on its proposed investments through higher airport charges, even if those investments are not actually realised in the course of the regulatory period or are not what the users want or need. A return should only be allowed if the money is actually spent on investments that are wanted by and agreed with users. Indeed, the inherent risk of RAB based regulation leading to developments at regulated airports which do not meet the needs of users and are over-specified was expressly recognised by the UK Competition Commission. If the current regulatory approach is to be retained in its present form, the DACC would likewise expect the Commission to take a very proactive role in evaluating DAA's capital investment programme and ensuring proper consultation. If inefficient investment is allowed into the RAB, this will fundamentally undermine the incentive properties of regulation. It would be wholly unacceptable for the Commission to step back and claim that it is not for the Regulator to get involved in the detail, especially given that there has been no effective form of constructive engagement between DAA and its users to date.

The Issues Paper raises the subject of clawback. The DACC considers this to be a critical issue as the Commission's statutory objective to secure the financial viability of DAA gives rise to an effective indemnity in favour of DAA in the event of a shortfall in revenue, such as the suggestion in CP6/2007 that depreciation might be accelerated in the event of any shortfall in relation to the funding of T2. Hence, users believe it is only reasonable that any outperformance arising not from the efficiency of DAA but from the actions of users should be clawed back to the benefit of users.

Quality of Service

The DACC sets out a number of general comments in relation to service quality at Dublin Airport in its response to the Commission's Consultation Paper CP3/2008 of June 2008. In that response, we noted inter alia that a regulated monopoly has strong incentives to decrease service levels under the current regulatory system and to retain the resulting alleged 'cost savings'. We also expressed our support for the introduction of service level agreements and penalties for failure to meet agreed levels of service. We note that the CAA's recently published proposals for Stansted Airport[9] places particular emphasis on service standards.

The DACC therefore welcomes the Commission's decision following this consultation and its conclusions in the Issues Paper that there is a case for providing *"clearer and sharper incentives for the DAA to deliver an appropriate quality of service at Dublin Airport"*. We note the Commission's intention to do this by publishing regular updates on DAA's quality of service performance, and also to include a quality of service term in the price cap formula. We agree that the service quality term in the price cap should penalise DAA if it fails to deliver services to the agreed standards, but should not reward DAA with a bonus if it exceeds the quality standards identified in the price cap (in contrast to the system at Heathrow and Gatwick, which does have a bonus element, but in line with the most recent CAA proposals for Stansted, which does not include a bonus element). We also agree that it should be for users, and not DAA, to identify the combination of price and quality of service that they would like to receive when using Dublin Airport.

In terms of the appropriate level of income that should be at risk, we would draw the Commission's attention to the recent CAA proposals for a Service Quality Rebate (SQR) scheme at Stansted Airport, in which the CAA agrees with the Competition Commission that an appropriate range for the total amount of airport charge revenue at risk under such a condition would be similar to the range proposed for Gatwick, i.e. 5-10%. The CAA is now proposing to adopt the same level of 7% at Stansted Airport, and with broadly the same relative weightings, as it did for the service quality rebates condition at Gatwick[10]. We see no reason why the same level of income should be not be at risk if Dublin Airport fails to meet agreed standards of service.

In terms of the potential quality of service indicators set out in the table at paragraph 3.8, the DACC considers there is far too great a reliance on subjective measures from passenger surveys and insufficient reliance on hard objective measures. The DACC notes that in the Heathrow SQM measures shown on page 13, only 25% of the value of rebates is ascribed to subjective measures derived from passenger surveys. The DACC considers that this is an upper bound on the proportion of rebates which can be dependent on passenger survey information. At least 75% must be related to hard objective measures related to features of the airport service which can result in delays or other costs to airlines. The DACC would agree that Security and Baggage Handling would be very important items for inclusion. Other items might include the PRM service, availability of lifts, stand availability. Defining the SQM measures will require detailed discussion between

[9] Stansted Price Control Review, UK Civil Aviation Authority, Dec 2008.
[10] Stansted Price Control Review, UK Civil Aviation Authority, December 2008, paragraph 7.40.

DAA, the Commission and the DACC to agree the measures to be included and target service levels.

As indicated above, the DACC considers that only a minority of the measures should relate to subjective passenger surveys. The DACC is also concerned at the suggestion that the ACI survey should be used in view of the limited sample and the fact that it is a self-completion questionnaire. If such measures are going to be used to define financial penalties, it is imperative that the data collection is robust, based on minimum sample sizes and capable of looking at differences in quality at different times of the year.

The DACC considers that a rebate system must operate over periods not less than quarterly as an annual system would run the risk of serious system failures in the peak summer period being obscured by apparent adequate performance taken over the year as a whole. This is addressed in the UK SQR schemes through the use of dead-band periods, with rebates payable monthly in arrears based on rolling performance measures, which the Commission is urged to investigate further.

Passenger Forecasts

The DACC is actively involved in a Forecasting Working Group with DAA, which the Commission attends. This Group has not yet completed its work, although three key issues are apparent from the work to date:

- lower GDP projections in the light of the current global economic downturn;
- the effect of increased taxes and charges on the rate of growth at Dublin; and
- the impact of runway capacity constraint up until the opening of the new runway in 2013 or later.

The Group is working towards achieving a set of forecast scenarios by early February to reflect different combinations of future circumstances. However, it will be important to update these by reference to the latest GDP projections at a later date to inform the final regulatory process.

If agreement can be reached between DAA and the DACC, it would seem appropriate for the Commission to adopt those forecasts, consistent with the UK CAA's approach to forecasts under constructive engagement at Heathrow and Gatwick. However, if agreement cannot be reached, the Commission will have to take its own view and have regard to the views of users, as opposed to simply relying on forecasts advocated by DAA.

It will be important that the forecasts inform not only the assessment of opex and commercial revenues but also the timing and scale of capital investment required and when such investment should enter the RAB.

Operating Expenditure

The key point which the DACC wishes to re-iterate at the outset of any discussion concerning operating expenditure (opex) is that the current economic crisis, in which airlines are faced with having to make severe cutbacks in their operating expenditure, makes it imperative that the DAA similarly find operating cost efficiencies within its business which can be passed on to its customers. The DACC has asked DAA for its proposals in this regard but has been repeatedly ignored, although recent press statements would suggest some recognition by DAA of the need to address its cost base. The DACC believes that the Commission should approach consideration of DAA's opex in the context of the prevailing economic crisis, which would certainly require DAA to respond to rising operating costs if it were operating in a competitive environment, as do its customers. DACC believes that the DAA's opex is excessive and inefficient and that DAA is purposely inflating its opex in order to game the regulatory system.

Because of the structure of the regulatory process, DAA has an incentive to make opex savings over and above the forecast made at the beginning of a regulatory period, because the Airport can retain whatever savings it is able to make for the remainder of the period. However, this incentive can also act to encourage DAA to underestimate the extent of potential efficiencies that could be made or else to make savings at the expense of service standards. The Commission should take steps to ensure that such regulatory gaming does not take place, including ensuring proper consultation and the provision of adequate information by DAA to users.

A key issue is how to identify opex efficiency gains. Most measures of such efficiency gains make use of an equation in which categories of operating expenditure are compared with passenger throughput. In cases where a proportionately similar number of passengers are handled for the same or lower operating cost, it is assumed that an efficiency saving has been made. However, this kind of simplistic approach can be misleading. For example, a lower value of opex per passenger is not necessarily a sign of real efficiency gains if the extra passengers were handled in existing downtime or at a reduced level of service. True efficiency gains can only be verified by taking a more holistic view when evaluating opex performance, which cannot be properly assessed by considering a few isolated statistics. We return to this point below.

A key question for the Commission is the extent to which DAA is already operating at an efficient level or whether there is a degree of 'catch up' to be done, in terms of the reaching the 'frontier' of airport efficiency. Current data suggests that DAA has significant catching up to do. We set out in the **Table 1** below a comparison of aggregate opex at BAA airports in recent years compared with Dublin's aggregate opex for 2007 (as quoted by the Commission in the Issues Paper – data for previous years is not currently available to us).

Table1: Opex Benchmarks					
		2004	**2005**	**2006**	**2007**
Heathrow	Opex (m)	£457.90	£496.80	£554.10	£599.80
	Pax (m)	64.261	67.654	67.421	67.305
	Opex/Pax	**£7.13**	**£7.34**	**£8.22**	**£8.91**
Gatwick	Opex (m)	£184.30	£193.70	£223.40	£225.40
	Pax (m)	30.057	32.007	32.845	34.383
	Opex/Pax	**£6.13**	**£6.05**	**£6.80**	**£6.56**
Stansted	Opex (m)	£81.40	£90.50	£100.50	£114.70
	Pax (m)	19.409	21.169	22.237	23.845
	Opex/Pax	**£4.19**	**£4.28**	**£4.52**	**£4.81**
Dublin (euros)	Opex (m)				€185.8
	Pax (m)				23.3
	Opex/Pax				€7.97
Dublin (GB £, avg 2007 rates)	Opex (m)				£127.15
	Pax (m)				23.3
	Opex/Pax				**£5.46**
Source: BAA Regulatory Accounts and CAR Issues Paper					

As can be seen from this data, Dublin's average opex per passenger is not as high as Heathrow or Gatwick, but significantly exceeds Stansted, which is more representative of the traffic mix at Dublin currently. Whilst this comparison is limited by the data available to us, it does *prima facie* suggest scope for improvement of baseline performance at Dublin and we would urge the Commission to investigate further in the course of its review. In terms of benchmarking, it is essential that relevant airports are chosen in terms of the mix of traffic, types of airlines, point to point role etc. Moreover, the BAA airports would certainly not be considered reliable benchmarks given that they suffer from the same perverse incentives under the same regulatory system. We consider the Commission needs to carry out significantly further work to benchmark opex in general and by process rather than rely on a simplistic assumed elasticity based approach.

Clearly it is important to examine opex from the point of view of its individual components as well as an overall value. Not all categories of opex are the same and each needs to be considered in context. Some opex is related to passenger growth and some is not. That which is related to passenger growth can show a varying elasticity depending on the nature of the expenditure. Opex can also be affected by 'one-off' or atypical items of expenditure such as new security directives, or step changes in utilised infrastructure capacity.

The DACC believes that the Commission should focus in particular on employee costs. Table 4 of the Issues Paper shows DAA staff costs rising as a percentage of opex (from 60% in 2001 to 64% in 2007). This needs urgent further investigation. The DACC also notes DAA's recent admission that its payroll bill has been growing by 7% to 8% per annum in recent years and that such growth is unsustainable[11]. Individual elements of employee costs should be examined in detail, including, for example, general wage rates, levels of overtime, sickness rates, administrative on-costs, and pensions.

We note the Commission's interest in the individual elasticities to be applied to the various components of opex, and although we do not wish to make detailed comment at this stage on each particular value, we note that the Commission used an overall weighted average elasticity of 0.42 for staff costs and 0.45 for other opex costs in its Determination of 2005. These overall figures appear to be quite high. In the UK, Manchester used a fixed opex elasticity of 0.33 for its fourth regulatory period and the UK Competition Commission's analysis of elasticity in its 2002 Report suggested that the overall value ought to lie between 0.3 and 0.4. In its recently published proposals for the 5th regulatory period (Q5) at Stansted Airport, the CAA has used an overall elasticity of 0.3[12].

Whatever elasticities are used, however, it is important to note that these only serve to indicate what additional level of operating expenditure could be expected to be incurred in relation to a particular level of traffic growth. They do not therefore 'push the frontier' and it would be reasonable to expect that further efficiency improvements could be targeted over and above these values. The extent of these annual efficiency improvements would be expected to range from between 1% and 1.5%, which are the values used by the UK Competition Commission and the CAA in the regulation of BAA Airports. The CAA has used 1.5% in its most recent proposals for Stansted Airport, referred to above.

The Commission should also consider benchmarking Dublin Airport's opex costs and efficiency levels against other European airports. However, it is important that appropriate comparisons are selected. DAA continues to make the claim that its charges are competitive, but it habitually compares itself with hub airports that have substantial volumes of high-yield and long-haul traffic including transfer passengers, whereas the majority of traffic at Dublin Airport is low-cost, short-haul, and point-to-point.

Taking all these considerations into account, the DACC believes that the Commission's approach to the evaluation and forecasting of opex should not focus on any single measure or calculation at the expense of a more holistic approach to the varying components of opex. Such an approach, in general terms, would include:

- a 'bottom up' review of all of the individual components of DAA's opex, with a particular focus on employee costs;
- a 'top down' benchmarking of DAA's opex costs against the performance of other appropriate and comparable airports in Europe;
- a consideration of economy-wide trends, particularly in the light of current economic conditions;

[11] The Irish Times, 18 December 2008.
[12] Stansted Price Control Review, UK Civil Aviation Authority, December 2008, paragraph 3.64.

- the establishment of a baseline of cost, which may require one-off and atypical costs to be removed or treated separately;
- the application of appropriate individual elasticities going forward, with an overall weighted average elasticity that lies close to a value of 0.3;
- the setting of appropriate annual opex efficiency targets, which we would expect to be set at a minimum of 1.5%.

In taking this kind of approach to evaluating and forecasting opex, the Commission should also be mindful of the fact that it is regulating a monopoly provider and that the introduction of some form of competition, wherever possible, is likely to be preferable to the provision of monopoly services. The Commission should therefore consider whether there is any scope for DAA to contract out operational services or to market-test certain services and whether such contracting out or market-testing could produce significant cost savings. Clearly, however, any contracting out of services would have to be accompanied by safeguards to ensure that DAA does not shirk its responsibility to ensure that services are provided at satisfactory levels of quality.

Ideally, competition should be introduced in the form of an independent operator for T2 and the DACC urge the Commission to ensure that the Government complies with its undertaking in the Decision on T2 to appoint an independent operator and for such an appointment to deliver efficient operating costs.

The Commission also raises in its Issues Paper the question of whether certain other issues might affect the forecasting of opex, specifically T2, PRM services, and Dublin Airport City.

With regard to T2 operating costs, the DACC considers that, given the downturn in passenger numbers, it will be important that the additional operational costs associated with T2 are proportionate to the benefits to users, i.e. proportionate to the incremental passengers which can be handled having regard to runway capacity constraints in peak hours and the existing capacity in T1. The additional operational costs associated with T2 should not constitute a step change on a per passenger basis and to the extent that new T2 related operational costs are added there should be reductions in the operating costs of T1 reflecting the reduction in throughput. In other words, the operation of T2 should not be allowed to cut across the overall objective to secure improvements in opex efficiency at Dublin Airport in the short as well as the long term.

Whilst an open competitive tender for the operation of T2 may provide some benchmark for operating costs at Dublin Airport, there is a danger that the physical characteristics of the building may result in operating costs being higher than necessary. There is a particular danger that the opening of T2 will bring about a step change in opex, with no equivalent reductions in T1, and without any step change in demand. This would be the worst of all possible worlds for users, as it will dramatically increase costs without the possibility to spread them over additional passengers.

The Appeal Panel recognised that this review will need to consider the triggers for when T2 becomes operational in the context of when the capital costs are allowed into the RAB[13]. This is an important issue in relation to operational as well as capital costs. When it is determined that T2 needs to become operational, the Commission will need to find a mechanism to smooth the impact of the introduction of T2 in order that it does not result in a step change in the cost of using Dublin Airport.

With regard to PRM charges, the DACC has substantial concerns about the process by which DAA appointed the supplier and has objected to the process as having resulted in excessive charges. The Commission's recent Notice CN5/2008 sets out in paragraph 3.6 the main concerns expressed by users over the introduction of this charge, and notes the Commission's acknowledgement of the failure of the DAA to co-operate with users in the manner intended in the Regulation and the fact that the proposed charge does not satisfy the transparency criterion. The Commission must now take a robust approach to this failure properly to consult with users, and disallow the increased costs.

With regard to Dublin Airport City, the DACC's position is very clear. This project should be wholly excluded from the Single Till and its costs should be borne entirely by DAA at its own risk. The Commission should also require DAA to demonstrate how it has ring-fenced these costs. We return to the issue of Dublin Airport City under the heading of Financial Viability below. This will involve stripping the costs of land out of the RAB.

With regard to rolling efficiency incentives, which is raised by the Commission in the Issues Paper, the DACC has already set out its views in its response to CP4/2008, which dealt with this issue specifically, and does not have further detailed comment to make at this stage.

Commercial Revenues

The quantum of commercial revenue earned by DAA is an important regulatory building block and, at a superficial level, it is clear that the greater the level of commercial income under the Single Till, the lower the airport charges to airlines. It would therefore be expected that DAA should be incentivized to maximise commercial revenue wherever it can. However, more complex considerations lie behind the assessment and forecasting of airport commercial revenues, which we address below.

Like operating expenditure, commercial revenues can be categorised under a variety of disparate headings, and like operating expenditure, each type of commercial revenue needs to be considered separately in order to fully understand the whole. However, at an aggregate level, we note that DAA's commercial revenues per passenger have declined from €8.36 in 2001 to €6.60 in 2007. Furthermore, the report of May 2005 commissioned from Alan Stratford &

[13] Decision on Aer Lingus Appeal, paragraph 9.1

Associates, noted that a benchmarking analysis using 2002 data indicated that Dublin only raised the equivalent of 48.6% of the level of commercial income per passenger raised on average by European Airports as a whole. On the face of it, therefore, the DAA has considerable ground to make up. Before we consider what approach the Commission should take to evaluating commercial revenues, we set out a number of issues which need to be borne in mind.

First, there is an important balance to be struck between airport operational requirements and the use of terminal space for commercial purposes. Additional commercial income should not come at the expense of the airport's or the airlines' ability to process passengers. Furthermore, this is not simply a question of the volume of terminal space allocated for commercial purposes. DAA should be assessed in terms of its ability to increase commercial revenue from existing space by increasing footfall and market penetration and by better matching retail offers to the prevailing passenger mix. The right balance between terminal catering and terminal retail outlets and the level of commercial income that can be earned from each, also needs to be managed effectively.

Second, there is the question of the incentives on DAA to maximise commercial revenue and the associated issue of who should benefit if commercial revenue exceeds the forecast implicit in the price cap. As we have noted, commercial revenue is an important regulatory building block, although it acts in an opposite way from operating costs in determining the price cap. The incentive for DAA to increase commercial revenue beyond forecast is generated by its ability to retain revenues in excess of forecast for the duration of the regulatory period, but as with opex, this also brings perverse incentives. The potential problems include:

- the fact that this is also an incentive on DAA to underestimate commercial revenue potential in the forecasts;

- the fact that the incentive could also encourage DAA to maximise commercial revenue at the expense of operational requirements;

- the fact that the incentive also acts to encourage arbitrary increases in non-regulated charges to customers after a determination has been made, such as what was experienced in relation to check-in desks and SSKs, thus increasing the levels of revenue that can be retained by the DAA without being offset in the price cap;

- the fact that airlines do not share in any additional commercial revenue earned by the Airport in excess of forecast, despite that fact that it is ultimately the airlines that bring passengers to the Airport.

A critical issue identified in the Issues Paper relates to T1X. In CP6/2007, it was clearly stated that the costs of this were only being allowed into the RAB on the basis that the effect would be revenue neutral because of the <u>incremental</u> commercial revenue to be earned from the development. The Commission will need to develop a mechanism to verify that these incremental revenues do match or exceed the annualised costs arising from the inclusion of T1X in the RAB. Otherwise, some part of the costs at least will need to be stripped out from the

RAB. A critical issue will be to determine that the revenues are genuinely incremental – it will not be sufficient to simply add up the commercial revenues from those outlets within T1X as this would ignore any consequential shortfalls in revenue from existing outlets. Of particular concern to the DACC is the fact that, in consequence of the demolition of Pier C, the footfall past many of the existing retail outlets has diminished since the opening of Pier D. T1X may simply replace that lost income, in which case it would not be genuinely incremental. The DACC will expect the Commission to investigate this thoroughly by reference to trends in income from all outlets over the current regulatory period to ensure that the full impacts are understood.

The DACC believes that excessive space in T2 for retailing (e.g. 5 stories instead of 2) means that the commercial revenues are unlikely to cover the associated costs and the Commission should therefore require DAA to bear the risk for proceeding with such an excessive and inefficient development. In other words, either costs should be stripped out of the RAB or the Commission should take steps to ensure that there is no dilution of commercial revenues per m^2 by dint of the larger floor area. Users should be indemnified against any potential shortfall in commercial revenue in relation to the cost and value of the space provided for commercial facilities.

There is also the question of the scope of the current definition of commercial revenue and the current treatment of non-regulated charges imposed on airlines by DAA for access to airport installations such as check-in desks. As we noted above, these can be arbitrarily increased by DAA and the regulatory incentive acts to encourage this. The Commission issued a consultation document (CN2/2008) in March 2008 in connection with this issue, to which the DACC responded on 9th May 2008. In this response, we set out our belief that DAA were double-charging for the cost of check-in desk facilities that were already being recovered through regulated airport charges. Despite this, the Commission allowed the additional charges, but set out options for the treatment of such charges in future. The DACC repeats its view that such charges should be treated as regulated airport charges, given that they are an essential and unavoidable part of the service that the airlines are forced to purchase from DAA as a monopoly supplier. We also noted that requiring DAA to pre-commit to a price path for such charges (and this should be a price commitment rather than a revenue commitment, because a revenue commitment could place a further cost burden risk on airlines if demand were to fall thus allowing prices to be increased) would be less satisfactory but would nonetheless be an acceptable fallback position if the preferred solution could not be implemented. The Commission may wish to refer to the conclusion of the UK CAA on non-regulated charges at Heathrow and Gatwick and set out in Chapter 6 of its Decision of March 2008 on the economic regulation of these airports. Public Interest conditions are in place at the UK regulated airports which govern the level of such charges.

In summary, therefore, the DACC believes that the Commission's approach to the analysis and forecasting of commercial revenue should not be confined to simple ratios or indicators. The Commission should establish whether Dublin is managing its commercial income generation efficiently and whether it can improve performance without using more space or building new infrastructure. A base should be established and challenging targets for improvement should be set. Based on investigation by the UK Competition Commission and the CAA in the course of recent regulatory reviews of BAA Airports, we would expect the elasticity of commercial revenues in relation to passenger throughput to be approximately 1, although this would assume that the starting point is correct and that DAA is already operating at the 'frontier' of airport performance, which could only be determined by a 'bottom up' review of the various components of commercial revenue.

In terms of incentives, the DACC believes that users have a legitimate reason to expect to be able to share in the value of any over-performance by DAA in terms of exceeding forecast commercial income, given that it is the users who bring the passengers to the airport in the first place (this is of course a key feature of the justification for the Single Till approach to regulation). We do not believe it is appropriate for DAA to retain the whole of any such regulatory 'benefit' for the full regulatory period when such benefit could be passed on to users in the form of lower airport charges. However, we recognise that if all the benefit were to be passed on to users, this would effectively remove the incentive on DAA to outperform its commercial revenue targets. Nevertheless, given that commercial revenue is such a key element of airport profitability and is not subject to direct regulation, we believe that sufficient incentive still remains for DAA to ensure that this source of income is maximised as far as is possible.

Capital Costs

It is a matter of continuing concern to the DACC that the DAA has failed to provide, despite numerous requests, a central business plan for the Airport. Consultation in relation to future capital investment plans has again broken down, in part due to the failure of the Commission to progress the appointment of an independent chair. The DACC welcomes the suggestion of the Commission at paragraph 7.16 that it will be willing to host consultation meetings in relation to capex. The DACC considers this should go beyond a hosting role and extend to a facilitation role to try to seek agreement, a process that was highly successful under the UK Competition Commission and led to several hundred million pounds being deducted from capex at Stansted.

The future capital requirements will need to be set firmly within the context of the current market conditions and updated forecasts for growth. In the light of current expectations of market performance, the DACC considers that capital expenditure requirements for the next regulatory period should be limited largely to care and maintenance. In particular, the DACC can see no case for any significant expenditure on refurbishing T1 and questions the timing of the need for the new T2 car park and hotel.

More fundamental concerns relate to the opening RAB, in particular the treatment of costs relating to Pier D and the terminal link, which are excessive and were incurred against the express wishes of users, and of Pier C. The latter pier has effectively been demolished as part of the T2 project and the DACC would therefore expect the un-depreciated value of the asset to be stripped out of the opening RAB.

As identified in the Issues Paper, the trigger for T2 Box 1 costs entering the RAB is critical. The DACC does not consider that the trigger 'operationally ready' should be taken to mean that DAA can start to recover the costs of T2 before there is demand to use the new terminal, which will not occur until the parallel runway is ready. Users should not begin to pay for T2 until such time as they gain beneficial use of the terminal. The trigger should be demand exceeding a particular threshold in T1 and/or the provision of additional runway capacity enabling additional peak period departures, whichever is the sooner. It would be unfair to charge users for costs associated with T2 ahead of those conditions, as this would mean users paying for a facility from which they gain no benefit. The Appeal Panel made clear that it expected the Commission to give full consideration to these issues in the context of this review.

The DACC welcomes the decision of the Appeal Panel to refer back to the Commission critical items, such as the scale of T2 Box and Box 2 both by reference to the capacity available in T1 once Pier D, Area 14 and T1X are complete and by reference to the ceiling of 30 mppa established under the Fingal Local Plan and the planning cap of 32 mppa imposed by the approval to the construction of T2 by An Bord Pleanala. The DACC will expect a root and branch review of capex requirements at Dublin Airport, consistent with the overarching regulatory requirement to secure cost efficiency.

The Appeal Panel also made clear that it expects the precise manner in which depreciation of T2 costs is to be dealt with falls to be determined in this review[14]. The DACC generally favours a unitised approach, which delivers a smooth profile of charges reflecting ability to pay. The DACC is opposed to accelerated depreciation simply to maintain DAA's financial ratios unless it can be demonstrated that this is clearly in the interest of users.

Financial Viability

The Commission raises the issue of Dublin Airport City in relation to financial viability. The DACC is alarmed about DAA's proposals in relation to Dublin Airport City and associated investments. DAA has claimed that these investments will help reduce airport charges[15] but has not said how, as no supporting details on costs or demand forecasts have been provided. This statement also conflicts with DAA's claim that the Dublin Airport City Project will be ring-fenced and excluded from the Single Till. DAA has stated that the Dublin Airport City project would incur an initial spend of €300m rising to around €4bn over the next 30 years. This is a serious financial commitment, especially since DAA appears to have no idea at this stage how or whether the business case for such investment stacks up.

[14] Decision on DAA Appeal, paragraph 8.7.
[15] Presentation given by DAA (Jack McGowan) to DACC, 17 July 2008.

The DACC is seriously concerned about the lack of information from DAA as to what exactly is being planned and the financial case for the investment. In the absence of any detail or financial plan, we can have no confidence that this project will not impact on the Single Till and as a result on airport charges to users. We therefore call on the Commission to scrutinise very carefully DAA's proposals for Dublin Airport City to ensure that users do not end up paying for DAA's ambitions to be a property developer rather than an airport operator. There may need to be consequential adjustments to the RAB at the very least to reflect land transferred to the project.

The DACC has an overarching concern regarding how the Commission interprets its duty to ensure the financial viability of DAA. This cannot be simply to allow costs to users to rise to compensate for any shortfall in revenues but must extend to firmer scrutiny of whether costs are being incurred efficiently. Otherwise, this safeguard simply rewards inefficiency in a way that has wider adverse economic effects because of the potential to damage airline competition and increasing the cost of travelling to passengers.

DACC therefore calls on the Commission to prioritise its objectives in terms of protecting the reasonable interests of users and ensuring the economic and cost efficient development of the airport, which will, in turn, ensure the financial viability of DAA.

Other Issues

The DACC considers that the potential distortions associated with cargo and general aviation flights would be best dealt with by excluding revenues earned from such operations from the calculation of the price cap but to subject these prices to the same limits on the rate of increase as applied to the passenger yield cap. This is the approach adopted by the UK CAA at its regulated airports.

With regard to price cap compliance, the key is proper and adequate transparency and consultation. A first step could be a requirement for the DAA to publish its current and historic Regulatory Accounts on its website, as is done by the BAA.

Conclusion

In conclusion, the DACC welcomes the opportunity to respond to the Commission's Issues Paper. Fundamentally, the DACC considers that the Commission must learn the lessons from the UK Competition Commission's in depth investigation into flaws in the regulatory regime for airports and adjust its behaviour accordingly. This will require more detailed scrutiny of the regulatory building blocks than has been the case in previous reviews.

Current market conditions make it all the more important that incentives are placed on DAA to improve its cost efficiency. It will not be sufficient to rely on the incentive properties of regulation alone without ensuring that the starting position reflects already reasonably efficient operations. This may require some difficult choices to be made in terms of the level of the starting RAB, target operational costs and commercial revenues. Given the requirement for the regulator to create conditions to mimic the working of a competitive airport market, the starting point should be the performance of competitive, not monopoly regulated, airports and the regulatory outcome should seek to impose incentives on DAA to reach those levels of performance over the next regulatory period.

Appendix A

<u>Issues – General Approach</u>

Should the Commission continue with a CPI +/- X approach, using a single till, when setting the price cap? *The current regulatory approach is far from ideal and contains the potential for perverse incentives to apply and for regulatory gaming to take place. Nevertheless, the principle of this kind of regulation could work if regulation is applied with a firm hand and the Regulator is alive to the potential for regulatory gaming. It will be important for the Commission to be more proactive in verifying that costs, both opex and capex, are being efficiently incurred and in ensuring that the DAA is properly consulting with users.*

How should risk be treated? As stated in paragraph 2.13 above, the DAA currently bears all the risks, positive and negative, that the price cap is based on forecasts that turn out to be incorrect. Parties are asked to state if, and under what conditions, the Commission should deviate from this approach through 'clawbacks', ex-post reimbursements to the firm, or some other form of risk sharing. *The DACC does not agree that DAA bears any negative risk as the requirement for the Commission to always ensure the financial viability of DAA means that it will be reimbursed in the next regulatory period for any shortfall. In contrast, airline users bear the entire risk of prices being set too high, which is why it is important for users to be reimbursed in circumstances whereby their activities have resulted in DAA earning excess profits. Failure to do so would mean that clawback would effectively be asymmetric in favour of DAA. In this context, the Commission needs to be aware of the potential for incorrect forecasting to be exploited by the DAA in order to weaken the effect of regulation. Although the DACC is keen to ensure that the DAA faces appropriate regulatory incentives, these can only act effectively if the Commission examines the variations from forecast on a case-by-case basis before allowing DAA to retain additional profits resulting from such deviations.*

What should be the duration of the next determination? The Act requires that a cap last for a minimum of four years. Do parties consider four years appropriate, or would they prefer the cap to apply for a longer period? *The DACC believes that four years is an appropriate duration for the next regulatory period, particularly in the light of current market uncertainties such that setting a cap for a longer period might lead to distortions.*

<u>Issues – Quality of Service</u>

Are parties content to rely on the indicators for quality of service described in Table 1? If not, what changes would parties propose? *Quality of service is a key issue affecting the DAA's customers. The indicators as proposed are too reliant on measures from subjective passenger surveys, which should form no more than 25% of the rebate value, and not enough on objective measures of operational performance affecting airline delays and/or costs. There will need to* *be further discussion with the DACC to define the metrics and the target service levels.*

Should any quality of service targets that the Commission sets differ from the current levels at Dublin airport? If so, what implications are such changes likely to have for the DAA's costs? *The targets set should be challenging and seek to achieve a better quality of service from DAA than is presently delivered. We would expect DAA to be able to achieve improved service levels without significant cost increases, although any cost implications of changes to service levels need to be the subject of consultation with users. As the Commission has noted, it should be for users, and not the DAA, to identify the combination of price and quality of service that they would like to receive when using Dublin Airport.*

How should the Commission determine the structure and scale of any financial incentives it incorporates into the price cap to encourage the DAA to deliver service-quality targets? *The DACC believes that the Commission should draw from what has been suggested by the CAA at Stansted Airport in its recent proposals report (December 2008) and should ensure that penalties for failure to deliver adequate service quality have teeth and that DAA should not be rewarded with bonuses where service level targets are exceeded.*

<u>Issues – Passenger Forecasts</u>

What do parties think are key drivers of passenger growth trends at Dublin airport? *The main drivers are GDP and the impact of rising costs. A parallel exists here with the situation at Stansted, where the traffic impact of rising costs is mirrored in what is happening at Dublin.*

Are parties able to provide robust empirical evidence on the strength of the relationship between passenger numbers and any specific drivers? If not, can they suggest information that the Commission might collect in order to quantify possible relationships? *These matters are being discussed at the DAA/DACC Forecasting Working Group, which the Commission attends. Empirical evidence is being produced as part of that process and is available to the Commission.*

What forecasts might the Commission use to project values for other drivers thought to influence passenger trends? For example, if the Commission concluded that GDP growth or oil prices have been important drivers of passenger volumes at Dublin airport, what values should it assume for these series beyond 2009? *It will be essential that up to date forecasts, particularly of GDP are used.*

Issues – Operating Expenditure

What relationship do parties think exists between passenger numbers and opex? How significant are economies of scale? *We refer the Commission to the views we have set out in the body of this response, but in general terms the Commission should consider different kinds of opex in different ways in terms of their relationship with passenger numbers. The Commission should not rely on statistical measures alone, but should 'look behind' the figures to see where real efficiencies are being or can be made.*

What approach(es) should the Commission take to forecasting the DAA's opex needs? Which categories of the DAA's opex, if any, should the Commission review in detail? What weight should the Commission give to evidence on productivity from other airports or other sectors of the economy? *Again, we refer the Commission to what we have set out in the body of this response. The Commission's approach also needs to take into account the current economic climate, in which the DACC would expect the DAA to be finding ways in which it can reduce its operating expenditure and improve its efficiency, in the same way that its users are having to do.*

What categories of opex should be included in a rolling-incentive scheme? *With regard to rolling efficiency incentives, the DACC refers the Commission its previous response to CP4/2008.*

Issues – Commercial Revenues

What relationship do parties think exists between passenger numbers and commercial revenues? *We refer the Commission to the views we have set out in the body of this response, but in general terms the Commission should consider different kinds of commercial income in different ways in terms of their relationship with passenger numbers.*

How might the Commission forecast targets for commercial revenues that the DAA might collect during the next determination? What weight, if any, should be attached to evidence from the macro economy or from other airports? *We refer the Commission to the views we have set out in the body of this response, although in general terms the DACC believes that the approach to the analysis and forecasting of commercial revenue should not be confined to simple ratios or indicators. The Commission needs to look closely at the potential for commercial revenue increases, commissioning studies where appropriate as well as taking into account the current economic conditions.*

Are there any categories of commercial revenues for which the Commission should not provide the DAA with incentives to maximise the yield? If so, how should the Commission treat such revenues? *The DACC has identified the requirement for non-regulated (commercial) charges to airlines to be subject to incentives to minimise costs. Whilst the preference would be for these to be* *included within airport charges, the next best alternative would be for a binding commitment limiting increases in these costs to put in place. Furthermore,* we *do not believe it is appropriate for DAA to retain the whole of any regulatory 'benefit' deriving from outperformance of forecasts for the full regulatory period, when such benefit could be passed on to users in the form of lower airport charges.*

<u>Issues – Capital Costs</u>

What should be included in the RAB? How might the trigger that T2 "be operationally ready" before the first tranche of costs for this project are included in the RAB be defined in practice? *We have set out our views on capex and the triggers for T2 more extensively in the submission above.*

What approach to depreciation should the Commission take? *The DACC favours the unitised approach to depreciation of new assets as proposed by the Commission in relation to T2 expenditure but the timing when assets enter the RAB relative to the need for these assets still remains critical, as does the efficient cost of those facilities.*

How should the Commission determine a cost of capital for the DAA*? The Commission should consider the cost of capital in relation to DAA's absolute monopoly status serving the Dublin area. The DACC would therefore expect the cost of capital to be below that adopted by the CAA for the London area airports. The Commission should also take into consideration the substantial decrease in interest rates that has occurred as a result of the recent economic crisis.*