Maximum Levels of Airport Charges

at Dublin Airport

Final Decision on Interim Review

of 2005 Determination

Commission Paper 6/2007

30 July 2007

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FOREWORD

I am pleased on behalf of the Commission for Aviation Regulation to present this Report on the final decision of the Interim Review of the Determination on the Maximum levels of Airport Charges that may be levied at Dublin Airport by the Dublin Airport Authority in the regulatory period 2006-2009.

This Report sets out the final decision on the interim review of the September 2005 Determination and the reasons for making this decision. It also clarifies the Commission's approach towards the treatment of capital expenditure for the next regulatory period.

The Commission retained a number of consultants to assist in evaluating the investment plans and in gathering and analysing data for the purposes of completing this review. The work undertaken by the consultants is referred to in this Report and earlier reports leading to this Decision.

I would like to thank all interested parties who have made submissions to the Commission or attended workshops and information meetings. These contributions greatly assisted the Commission in its consideration of the issues arising. This Report includes, under the relevant headings, the Commission's response to all submissions received.

Cathal Guiomard
Commissioner

30 July 2007

1. INTRODUCTION

This Paper sets out the final conclusions of the Commission for Aviation Regulation ("the Commission") on the maximum level of airport charges that may be set at Dublin Airport following the Commission's Interim Review of its 2005 Determination. The Commission published a Draft Decision on 21 May 2007.[1] In reaching its final decision the Commission has carefully considered submissions received from nine parties – Aer Lingus, bmi, Chambers Ireland, the Dublin Airport Authority (the DAA), the International Air Transport Association (IATA), the Irish Business and Employers Confederation (IBEC), the Irish Tourist Industry Confederation (ITIC), Portmarnock Community Association (UPROAR), and Ryanair.[2]

The Commission has decided not to change the existing Determination. It is satisfied that the finalised 2006-2009 capital investment programme (CIP2006) of the DAA can be financed without changing the existing cap on per passenger airport charges that the airport may levy.

The Commission also sets out its proposed approach at future price determinations to funding the DAA's planned investments in the next two years. The general approach outlined in the Draft Decision continues to represent the Commission's position.[3] There will be a "two-box approach" to including the costs of Terminal 2 (T2) in the regulatory asset base (RAB). On completion of the T2 project €622 million will be included in the RAB.[4] A further €101 million will be added if and when passenger numbers exceed 33 million passengers per annum (mppa). (The values for the two boxes and the passenger threshold for box two to enter the RAB have both changed since the Draft Determination, for reasons explained later in this Report.) Rather than straight-line depreciation, the capital costs for T2 and associated projects will be unitised for the purposes of estimating future price caps. The Commission will seek to ensure that the Terminal 1 extension (T1X), if it proceeds, has a neutral effect on charges. The costs of Pier D will be reviewed at the

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[1] Commission for Aviation Regulation (2007) "Draft Decision Interim Review of 2005 Determination on Maximum Level of Airport Charges at Dublin Airport", Commission Paper 5/2007.
[2] Redacted copies of all the submissions received are available at the Commission's website (www.aviationreg.ie).
[3] See Commission Paper CP5/2007, and in particular Sections 7 and 8.
[4] Unless otherwise stated all prices in this document are in September 2006 terms.

time of the next Determination, along with all the constituent parts of a "building-blocks" approach to setting the price cap – net operating costs, passenger forecasts, the cost of capital, and future capital expenditure needs.

Future determinations will continue to be set so as to allow the DAA to recover reasonably incurred costs that meet the needs of current and prospective users. The Commission received comments critical of some of the assumptions underlying the indicative price cap included in the Draft Decision. The Commission accepts that the price path will vary according to the final conclusions reached on the various components in the building-blocks approach. It does not propose to reach a final conclusion on these components now. Consequently, this decision refrains from suggesting a final price path for the 2010-2014. Instead, it limits itself to indicating what capital expenditure in CIP2006 undertaken before 2010 will be included in the RAB at future determinations. The Commission will be happy to provide interested parties, including users and investors, with indicative price paths for a given set of assumptions, should they consider this helpful for their purposes.

The remainder of this Report is structured as follows:

- the Commission's Decision on the Statutory Review is contained in Section 2;
- the Commission's approach to setting future determinations, and in particular its proposed treatment of capital expenditure undertaken by the DAA before 2010, is discussed in Section 3;
- evidence of how this decision is consistent with the Commission's statutory obligations is outlined in Section 4.

There are also three annexes to this Report – two containing reports by Rogerson-Reddan and Vector Management Limited (RRV) and one a report by IMR Solutions – addressing specific points made by parties following publication of CP5/2007. This Report assumes that the reader has access to earlier Commission papers, in particular the Draft Decision (CP5/2007).[5]

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[5] All Commission Papers can be found at the Commission's website and are available free of charge on request.

2 REVIEW OF THE EXISTING PRICE CAP

2.1 The Draft Decision

In CP5/2007 the Commission set out the preliminary conclusions of its Interim Review of the 2006-2009 price cap. The purpose of this Review was to afford the Commission an opportunity to reconsider the existing Determination in the context of the DAA's finalised capital expenditure programme (CIP2006).

CIP2006 requires considerably more capital expenditure than the Commission had regard to in its 2005 Determination. The DAA proposes spending €1,178 million, compared with the €571 million of capital expenditure considered by the Commission at the time of the 2005 Determination. If the model that generated the prevailing price cap was changed solely to include the expenditure levels set out in CIP2006 it would require a significant increase in the maximum passenger charge for the remainder of the regulatory period.

Despite the significant increase in the DAA's capital expenditure, the Commission's Draft Decision proposed no change to the 2005 price cap. Financial modelling by the Commission indicated that the extra revenues accruing from the increase in passenger numbers above forecast almost exactly offset the proposed increase in capital expenditure. Since the increase in proposed capital expenditure was partly motivated by the increased passenger numbers, it seemed logically inconsistent to calculate a revised charge based on an out-of-date passenger forecast while revising upwards allowed capital expenditure motivated by higher passenger levels. The Commission was also keen that the DAA should assume the risks (upside and downside) of deviations in passenger numbers from the traffic forecasts.

The three biggest items in the revised CIP were the costs of Pier D, T1X and T2. For Pier D, the Commission considered it inconsistent with incentive regulation to revise the price cap during the regulatory period because of a cost over-run. The DAA had presented the T1X project as having a neutral effect on charges because of the increased commercial revenues it would generate. Consequently, the Commission did not consider the costs of the T1X project warranted a change in the existing Determination. For T2, the Commission preferred linking higher airport charges with an improved airport experience, so favoured no change in the existing Determination while the facility was still under construction.

The Commission recognized that deferring the recovery of investments costs of the scale and scope needed to fund the proposed T2 may affect the financial viability of the DAA. It carefully considered various financial indicators, including those that debt ratings agencies consider when rating a company's debt, in particular the DAA's FFO:debt ratio.[6] In 2005 and 2006 these indicators had generally outperformed the Commission's expectations at the time of the 2005 Determination. Factors explaining this included the DAA's financial position proving stronger than expected at the end of 2005, a significant and unexpected growth in passenger numbers, and the sale of certain non-core assets. By updating the Commission's 2005 financial model to reflect these changes, the Commission was satisfied that the FFO:debt ratio would remain above 15% for the remainder of the current regulatory period, even allowing for all the additional capital expenditure the DAA proposes to undertake before 2010. The DAA had identified a 15% FFO:debt ratio as the minimum necessary if it was to maintain its investment grade.

Consequently the Commission took the preliminary view in CP5/2007 that it would be neither appropriate nor necessary to change its 2005 determination on the maximum level of airport charges at Dublin Airport.

2.2 Views Received in Consultation

The **DAA** expressed disappointment that there was not even a modest increase in airport charges for the regulatory period 2006–2009. It considered an increase would have signalled full funding for the planned infrastructure development as soon as the planning appeals process is complete. The submission included research that indicated that some users are willing to pay an additional airport charge to fund improvements to key services/facilities at Dublin Airport.

The DAA stated that it requires an average airport charge of €7.50 in the current pricing period, a level lower than the price of checking in a bag with many airlines.[7] It was concerned that the impact of continuing with the existing cap on airport charges did not address fully the DAA's concerns on financeability. It was unclear to the DAA to what extent the Commission's analysis had considered the DAA's forecasts for operating costs and commercial revenues as a result of changes to the investment programme. Some of the main areas that have experienced an increase

[6] FFO is an acronym for Funds from Operation.
[7] €7.50 is in 2004 prices. This equates to €7.90 in September 2006 prices.

in operating costs are in security regulations and increased passenger volumes through T1.

UPROAR considered current airport charges to be too low, as the charges do not reflect the opportunity costs of using the land at Dublin airport or the environmental costs. This led to high demand for services at Dublin Airport.

Chambers Ireland supported an increase to the proposed maximum level of charges to ensure that infrastructure can be developed to improve the quality of service that passengers experience at the airport. The increase in charges should be commensurate with the improvements passengers experience. Chambers Ireland did not specify the year(s) when charges should increase.

ITIC supported the Commission's proposal to not change price caps set in September 2005, given the strong growth in passenger numbers. This support was conditional on it not resulting in a downsizing of T2 or the delayed completion of the terminal.

Ryanair argued that the charges should be reduced. The number of passengers using Dublin Airport is much higher than forecast at the time of the September 2005 Determination. Moreover, the charges are based on the inclusion of unjustified costs in the RAB, such as the costs of Pier C and Pier D and financing costs for T2. Pier D's costs should be reduced to reflect the benchmarked costs of piers that are designed for use by low-cost carriers. Ryanair observed that it generates a large portion of the increase in traffic, uses a temporary pier with no discount for using these poor facilities, and is then subject to higher charges which take no account of the growth in passenger numbers.

The Commission's Response to Views Received

The statements made in CP5/2007 and reiterated in Section 3 of this Report provide a strong commitment about how the Commission intends to treat the DAA's proposed capital expenditure for the period 2006-2009. The Commission does not consider it necessary or appropriate to revise the existing price cap in order to strengthen this signal.

On financeability, the Commission carefully analysed the effect of projected changes in the DAA's net operating costs.[8] The Commission is satisfied that the existing cap on airport charges enables the DAA to operate Dublin Airport in a sustainable and financially viable manner between now and end 2009, even if the DAA's projections for net operating costs prove to be correct. In 2009, the Commission will have an opportunity, before setting the next Determination, to consider its assumptions about future operating costs and commercial revenues.

The Commission is keen that the airport charges users pay should relate to the quality of service provided at the airport. However, it does not believe that this provides a rationale for it to change the existing Determination. The projected improvements in the passenger experience will only materialise after the capital expenditure has been incurred. The possibility of introducing a sub-cap on individual charges that apply at the airport is outside the scope of this Interim Review.

The Commission never intended for this Review to reconsider all the arguments and data that contributed to its Decision in September 2005. Issues relating to the opportunity cost of land and environmental costs are issues outside the scope of this Interim Review. Hence, the Commission does not consider these issues raised by UPROAR warrant a change in the existing Determination.

The price cap should not be lowered because of higher than expected passenger levels. Under the existing formula governing the cap on airport charges, the DAA assumes the risks (positive and negative) of actual passenger numbers deviating from forecast passenger numbers for the length of the control period. Other than in exceptional circumstances, it would be inappropriate for the Commission to revise the existing Determination because of an increase (or decrease) in passenger numbers. For similar reasons, the Commission does not believe the existing price cap should be revised because of higher (in the case of Pier D) or lower than forecast cost outturns.

2.3 The Commission's Final Decision

The Commission has decided to implement the proposals set out in its Draft Decision and make no change to the existing Determination. The Commission remains

[8] See pages 46-51, Commission Paper 5/2007.

satisfied that necessary investment at Dublin Airport can proceed without revising the cap on airport charges between now and end 2009.

3 TREATMENT OF CIP2006 AT FUTURE DETERMINATIONS

3.1 The Draft Proposals

While the purpose of the Interim Review was to consider the Commission's 2005 Determination in the context of CIP2006, the Commission recognised that investors funding long life assets desire clarity about economic regulatory policy beyond the very short term, to the extent that it is possible to provide this. For this reason CP5/2007 set out how the Commission intends to treat capital expenditure incurred before 2010 in subsequent regulatory periods.

A review of the major projects in CIP2006 led the Commission to conclude that, for the specified investments in the DAA's plan, almost 95% of the proposed costs were reasonable cost estimates for the planned projects. Consequently, the Commission proposed to exclude the remaining €61 million of the proposed costs from the RAB on the basis that the costs indicated were excessive.

The available evidence suggested that the DAA had designed a new terminal with considerable excess capacity over what normally might be expected. The Commission was keen that the DAA, rather than the generality of airport users, should assume the demand risks associated with building a large T2. The Commission proposed a two-box approach. All of the costs associated with the first box would be included in the RAB when T2 opened. The remaining costs would be excluded from the RAB unless and until passenger numbers exceeded 30mppa. (The Commission also indicated a willingness to consider proposals from the DAA to recover box two earlier through alternative pricing mechanisms, provided these protected the generality of airport users from having to pay higher prices to fund additional capacity that they did not require.)

In addition to the two-box approach outlined above, the Commission proposed to depreciate the allowed costs for T2 using a unitisation method. This approach was favoured as allowing investment costs to be recovered equally across all forecast airport users, thereby ensuring a relatively small increase in charges upon commencement of T2 operations and a smooth progression of airport charges thereafter.

The Commission sought to ensure that T1X would not give rise to increased passenger charges, given that during consultation with users the DAA had indicated that the project would have a neutral effect on charges. Consequently, the Commission proposed to limit the return on capital and depreciation charges for this project to levels that did not exceed the forecast incremental commercial revenues that the project generated.

For other investments, the Commission indicated that it would apply straight-line depreciation from the date they enter the RAB. For Pier D, the Commission stated that it would review how to treat the forecast cost over-run at the time of the next Determination.

CP5/2007 also included a discussion of how the proposed treatment of these investments might affect prices following the next Determination. An illustrative price path for the period 2010-2014 was estimated, assuming

- Passenger numbers in line with the DAA's 2007 forecast;
- Capital expenditure set according to the approach outlined in CP5/2007 for projects commencing before 2010, and applying straight-line depreciation to capital expenditure for post-2009 investments at the level proposed by the DAA in CIP2006;
- Net operating costs continue to evolve according to the model used by the Commission in 2005; and
- An allowed pre-tax cost of capital of 7.4%

The resulting average charge derived using these assumptions was €7.78.[9] This yielded an average FFO:debt ratio greater than 17% during the period. The Commission was satisfied, having conducted a number of sensitivity tests that the proposed treatment of investments in CIP2006 that had been reviewed would be consistent with the need to enable the DAA to operate Dublin Airport in a sustainable and financially viable manner. The effects of changing forecast passenger number (+/-10%) or the cost of capital (+/-1%) were reported, with the outcomes showing average FFO:debt ratios exceeding 15% in all four cases. The Commission indicated a willingness to revise the depreciation profiles, accelerating them if it concluded that this was necessary to avoid the DAA encountering serious financial difficulties.

[9] Commission Paper 5/2007 erroneously reported this figure as €7.75.

The rest of this section discusses aspects of these proposals that attracted comments from interested parties. First there is a discussion of the various pricing policy options that the Commission has considered during this Interim Review. Then there is a review of the Commission's decision relating to the proposed costs of the CIP2006, including what proportion of these costs to include in the RAB and how they will be remunerated. This is followed by a more general discussion of the Commission's general approach to regulation. The section ends by addressing issues related to financeability.

3.2 The DAA's Consultation Process and the Needs of Airport Users

In the Draft Decision, the Commission reviewed the consultation process that had taken place relating to T2, T1X and Pier D. The Commission summarised its understanding on the extent of user involvement in the decision process affecting the costs and scale of these projects. The Commission invited interested parties to comment on this, including any corrections that might be necessary. It also emphasised that the requirements of users, rather than the quality of a consultation process should ultimately determine whether the DAA is allowed to recover the efficiently incurred costs of capital expenditure plans.

Comments on the Consultation and the Need for CIP2006

The **DAA** viewed its consultation process as being based on best international practice and approached in good faith. It criticised the Commission for its selectivity in its references to the overall consultation process. The Draft Decision failed to reflect the use of stakeholder management across the entire CIP programme of works. It also failed to consider the key stakeholder management documents and the evidence of consultation provided relating to T2, and that it contained inaccurate allegations of poor provision of cost information to users. In support of its arguments relating to the consultation process, the DAA included two reports:

- Turner & Townsend's "Response to Draft Decision Comments on CIP Consultation"; and
- the final ARUP report on T2 Stakeholder Management and Consultation Response to CAR Draft Decision.

The DAA argued that it was inappropriate to link the interests of users with the interests of airlines. The Draft Decision set an impossibly high hurdle for the stakeholder process by suggesting that ideally all stakeholders must reach agreement on proposed costs and implications for charges, before the capital expenditure is added to the RAB. This suggestion was unrealistic as airlines have conflicting commercial objectives and it did not consider prospective users' needs. The DAA warned the Commission that the airlines may be engaging in regulatory gaming whereby complete user approval is required before a project may be included in the RAB. The DAA encouraged the Commission to be aware that it consulted with each user and incorporated the majority of views during the process.

The DAA considered that a guidance note on consultation is critical and encouraged the Commission to engage in extensive consultation with the industry on its development.

In their submission, the DAA pointed out that the Commission should review not only the Stakeholder Management Report but the minutes from a series of monthly events for Airlines and Groundhandlers held in 2006, the DAA's Statement of Case which shows how the consultation process was in line with best international practice and the series of bilateral meetings between the DAA and users. The DAA explained that their consultation with Aer Lingus concerning T2 did not mean that other users of the airport were not kept informed of the T2 plans.

The DAA stated that users received the CIP positively with the exception of a "continuously negative and adversarial" user. Ryanair was described by the DAA as not interested in a rational exchange of views on developing the airport, but instead wanting a Frankfurt-Hahn type airport facility to suit its own agenda.

With respect to the information given to users on the costs of the capital programme, the DAA explained that users were given information once detailed discussions with users were scoped out, at the same time as the Commission and the Board received the information.

The DAA has presented the T1X project to users as a commercial project which will have a net contribution to the single till. The DAA recommended that the Commission postpone its examination of T1X until the next review as part of its assessment of commercial revenues.

The DAA referred to the 2002 consultation process for Pier D and said that it assessed eleven options with users. The DAA described the Commission's portrayal of events as being biased and unfair. It failed to understand how the Commission could suggest that users do not have a requirement for the revised specification of Pier D.

The Turner & Townsend Report outlined the policy, strategy and methodologies by which stakeholder management was implemented across the whole CIP to demonstrate that the scope of the consultation was wide ranging and best in class. The report was cited by the DAA as evidence that it had implemented thorough and genuine user consultation with all users and that during this process users gave their support for the finalised programme.

The Final ARUP Report described the level of engagement and information provided as exemplary for T2. It suggested that the Commission had not fully understood the level and extent of information presented to and discussed with stakeholders. ARUP also pointed out that the Commission did not take account of the cost information that was available to users in May and June 2006, which enabled comparisons between the T2 options and explained cost benchmarks. ARUP criticised Annex 4 of the Draft Decision for only referring to six of the CIP airline consultation events. All airlines and ground handlers at Dublin Airport were invited to ten CIP consultation sessions that provided them with an opportunity to comment on the planning and design of T2. In tandem with the consultation session, ARUP stated that users also had the opportunity to provide input at one-on-one meetings and through questionnaires. It was appropriate that Aer Lingus had a greater number of consultation sessions than other users, as they had a greater impact on the sizing of T2 and occupied a greater number of facilities in T2.

Aer Lingus in its submission described the consultation process that led to the current specification of T2 as fair and balanced. In their opinion, the DAA's consultation process was exactly the type of process that airports should have in place to determine the future capital developments that are needed.

bmi stated that it supported the T2 build, but "not in its current format and not at any cost."[10]

[10] Page 2, bmi (2007) "bmi Response to Commission Paper 5/2007"

IBEC expressed support for the CIP. It noted that Ireland's geographical location resulted in a high reliance on air transport and added that it is vital for businesses that high-quality infrastructure be put in place for the movement of people and goods. The development of T2 and additional piers, as designed, is essential.

Ryanair complained that the Commission had placed more emphasis on the process rather than the substance of the consultation process, especially in its references to the Boyd Creed Sweett report and the RRV report. Ryanair noted that the Gateway process was meaningless as the consultation at each step was ineffective.

It was unacceptable to Ryanair that they should be made pay for facilities whose specification and design it had not been consulted on. Consultation should take place among all users that are expected to contribute towards the recovery of costs, in a transparent, fair and equal basis.

Ryanair stated that the DAA did not consider lower cost options for its planned developments. As a result of this, Ryanair suggested that the DAA should not be allowed to recover the costs for these projects in excess of what meets the reasonable requirements of users. Ryanair was supportive of the Commission's comments in the Draft Decision that it will not allow the DAA to recover the costs of investment that users do not want and that projects will not be included in the RAB if users no longer considered the project to meet their needs.

Ryanair was critical that the Commission did not attend the consultation meetings and workshops arranged by the DAA with airport users. It noted that this exacerbated the problems of poor consultation on their facilities requirements as difficulties associated with the DAA's refusal to disclose information were not addressed. Ryanair included an Annex containing correspondence between Ryanair, the DAA and the Commission. This was offered as evidence by Ryanair to allege that the Commission had been aware of the failures of the DAA's consultation process since 2005. It suggested that the Commission attend all future consultation meetings between the DAA and users to ensure that there is proper consultation with users regarding all options.

Ryanair encouraged the Commission to learn lessons from the Stansted Constructive Engagement Process. It stated that constructive engagement only works when the airport operator is willing to disclose information and to engage in a thorough discussion of the options for all projects. Ryanair accused the DAA of not considering their T2 design. Ryanair suggested that the Commission become more actively involved in the consultation process to ensure that the DAA disclose all necessary information to all users.

Ryanair supported the Commission's plans to publish a guidance note on future consultation processes. Ryanair suggested that the consultation guidance should result in attendance by the Commission at all users' consultation meetings, that all options for development are consulted on and considered by the DAA, and that the DAA is encouraged to provide detailed information to justify investments such as forecasts, changes in the quality of service and commercial interests of projects. Ryanair also suggested that consultation determine the inclusion or otherwise of a project in a capital investment plan.

On the need for the projects reviewed in the Draft Decision, **UPROAR** argued that CP5/2007 had made references to CEPA's cost-benefit analysis to draw conclusions, but that CEPA's analysis was only preliminary. It assumed that the Commission would complete a more thorough analysis. UPROAR suggested that the cost-benefit analysis should include all elements of CIP2006, and that no project should be considered in isolation. UPROAR recommended that such analysis should incorporate the costs of road congestion, air pollution and noise externalities. It also argued that the value of land should be included when estimating the appropriate level of airport charges.

The Commission's Assessment of the Need for Investment at the Airport

The responses to CP5/2007 demonstrate a range of opinions on the merits of the consultation process. The Commission welcomes the fact that parties agree on the need to develop a guidance note on the consultation process. In developing that note, the Commission will consider the points relating to consultation that parties have raised responding to CP5/2007.

The Commission remains uncertain as to the effect users' views had on the DAA's selection of a specific option for T2. While there is no doubt that the DAA met with various users several times before the submission of the CIP, and ARUP suggest that the costs were presented as soon as they became available, Ryanair has claimed that its input in the consultation process had a minimal effect regardless of the number of meetings held.

Whatever the merits of the consultation process, the outcome is one where some users support the proposed expenditure, e.g. Aer Lingus, while others have expressed reservations, e.g. bmi and Ryanair. The Commission accepts that a consensus on the investment needs at the airport will not always be possible; it is also keen that users not be required to pay for investments tailored for individual users. Given the two Ministerial Directions and the comments received from a number of parties about the need for a second terminal, including from parties objecting to the DAA's specific proposals, the Commission has concluded that it is appropriate for it to include an allowance sufficient to permit the DAA to develop a second terminal and be remunerated without requiring users to pay for costs that are not regarded as necessary to meet their reasonable requirements.

The cost-benefit analysis undertaken by the Commission's consultants, CEPA, has helped the Commission to construct a charging structure that better aligns the benefits from an expansion in terminal capacity with the airport charges needed to recoup these costs. Specifically, the Commission has proposed to unitise (backload) the charges since there will be greater benefits accruing in the future, and the Commission has introduced a two-box approach to address concerns that the size and consequent cost of the proposed T2 might otherwise be too large relative to the benefits accruing. With these refinements, the Commission is satisfied that it has complied with its statutory requirements and it is therefore not necessary to conduct any further analysis.

3.3 Pricing Policy

In a consultation paper published earlier in the year the Commission sought the views of stakeholders on various pricing policies that might form the basis of a regulatory settlement to remunerate the investments in CIP2006.[11] The pricing policies on which the Commission consulted were:

- Trigger pricing;
- Peak pricing;

[11] See Commission for Aviation Regulation (2007) "Public Consultation on Dublin Airport Charges Following the Capital Investment Programme 2006", Commission Paper CP1/2007.

- Time profiling of charges; and
- Differential charges.

The views of parties who responded to the consultation are summarised in CP5/2007. The Commission considered these arguments and set out its proposals regarding these pricing issues in the Draft Decision.[12]

The following sections summarise the Commission's position, as outlined in CP5/2007, and the responses that the Commission has received on these pricing policies. The Commission's conclusions on these topics are then outlined.

Trigger Pricing

The Commission indicated that it would consider introducing an output-based trigger at the time of the next Determination should T2 not have opened by 2010. A trigger was seen as having the desirable properties of aligning increased prices with improved passenger facilities, and providing incentives for the DAA to complete projects in a timely fashion. These benefits were considered to be of particular relevance for large-scale projects, such as T2.

In response the **DAA** reiterated its opposition to trigger prices. It suggested that the use of triggers would imply a more interventionist regulatory regime and lead to micromanagement of its business. Triggers relating to T2 would be perceived by financial markets as adding additional risk, resulting in increased costs of financing the project. They could result in delaying remuneration of assets or even asset stranding.

The DAA sought clarification on whether recoupment of T2 investment costs depended on T2 being completed or in operation. It outlined a number of issues that could potentially delay the commencement of operations after its completion including: the likely tender for the selection of an operator; operational issues that may delay an airline in moving into the terminal; and industrial relations issues which arose in the context of Area 14.

The DAA perceived the use of the two-box approach for recovery of T2 investment costs as an 'effective trigger' and sought clarification on what basis the demand-

[12] See Section 6, Commission Paper CP5/2007.

contingent portion of T2's investment costs will be indexed for inflation and how capitalized finance costs will be treated.

Lastly the DAA argued that if triggers are introduced there should be a symmetrical treatment, allowing the firm to recoup costs early if investment is delivered ahead of schedule.

bmi supported the proposal to charge users only from the inception into service of T2. It also welcomed the Commission's suggestion that the DAA be incentivised to cease funding a project that was originally justified but which is no longer required. It gave the example of a possible reduction in air travel for environmental reasons that would make the need for extra terminal capacity redundant. It stated that, in such a situation, costs already incurred could enter the RAB but that further investment should be discouraged.

Time Profiling of Charges

The Commission proposed a 'unit-cost' method to recover the costs of T2. This would reduce (increase), relative to a straight-line approach, the depreciation charges allowed in the early (later) years of the asset's life. The rationale for this was to seek to have all passengers benefiting making roughly the same contribution towards the necessary capital expenditure. Revenues would be 'back loaded' so as to protect passengers in early years when usage is relatively low from having to pay more. The revenues the DAA collects would increase as passenger numbers increase over time.

In responding to the Draft Decision the **DAA** noted that depreciating the costs of T2 on a constant unit cost basis would significantly affect the company's levels of finance risk and overall financeability as returns would be much lower than they would be under the straight-line method. Because a greater proportion of remuneration would occur at future periods, the DAA identified risks associated with the uncertainty of future remuneration and risks associated with changes in the factors affecting remuneration. Back-loading of charges will result in the company committing to investment without certainty about how much remuneration it will receive or when.

The DAA argued that back-loading the depreciation charges increased the regulatory risk, since the calculations relied heavily on forecasts of passenger numbers. The

DAA thought it appropriate to have an upper bound in terms of passenger numbers used to calculate depreciation, as it is possible that passengers could pay higher charges in the future to cover the constant costs of T2 and the additional costs associated with extra capacity.

The DAA suggested that the likely price path would be 'peaked' as costs per total passenger will increase over time until the Commission's estimate of total capacity is reached and decline thereafter. The DAA stated that a smoother price path would arise if the unit cost method were applied to all airport users rather than those in excess of 18.5mppa.

The DAA also suggested that the rationale for unitisation and some of its desirable properties will be undermined by future 'stepped' changes in capital investment, such as a third terminal and ancillary investments. The DAA called for the Commission to explore the compatibility of the peaked charges profile in respect of the unit cost remuneration of T2 and future charges relating to further investments.

The DAA also argued that straight line depreciation charges should apply for Pier E and projects classified by the Commission in CP/5 as "T2 Additional Projects". Unit-cost depreciation should be limited to the T2 project, if it is to apply at all.

Ryanair and **bmi** both supported the Commission's proposal to back-load depreciation charges for T2, spreading the costs more equally across users over time.

Both Ryanair and bmi expressed concern about the Commission's indication that it would consider accelerating the depreciation profile if this was necessary to enable the DAA to operate Dublin Airport in a sustainable and financially viable manner. Ryanair argued that this would indemnify the DAA against any risk of imprudent or inefficient investment, transferring the risk of such investment to airline users. bmi sought further details on this proposal. It suggested that the Commission should ensure that there is no duplication of depreciation charges. If additional depreciation charges are allowed in earlier determinations, then future caps should take this into account. bmi also argued that rather than accelerating depreciation charges, the Commission should consider the possibility of the DAA realising cost savings if its financial viability is threatened because of changing passenger numbers or cost of capital.

Peak Pricing

The Commission did not propose to impose a peak charge in its next Determination to fund the investments reviewed in CIP2006. Although the Commission continued to believe that peak pricing can play a role in determining the efficient provision of infrastructure, for operational reasons the Commission felt it was better that such a charge be devised and introduced by the DAA in consultation with users. The Commission indicated that it was willing to allow the DAA to introduce a peak charge on T2 users if it wished to recover more of the costs of T2 in the early years of its operation.

In response the **DAA** stated that the peak-hour demand arises due to the operational requirements of low-cost carriers. To introduce peak charges would adversely affect home-based carriers. Because of airport competition, the DAA faced the risk that Dublin-based aircraft would relocate elsewhere if it introduced peak charges in Dublin.

The DAA suggested that imposing peak charges would mark a more interventionist approach to regulation by the Commission and an involvement in the day-to-day management of the company. It argued that the cap on runway off-peak charges introduced by the Commission in 2001 had created practical difficulties and unanticipated implications.

The DAA questioned the need for peak charges to demonstrate user demand for new capacity if the entire customer base at the airport were to support additional capacity.

The merits of using a peak charge in T2 as a means of recovering more of the costs of T2 in the early years were questioned by the DAA. It argued that users in both terminals generate the peak.

Aer Lingus also opposed a peak charge confined to T2 users. It argued that T1 and T2 are not distinct assets: T2 is merely an expansion of T1 capacity. If T1 and T2 were physically the same structure then there would not be a debate regarding the peak capacity. The Commission was confusing the value of centralising operations for an airline with the value of exclusivity. While it is an efficient outcome for the airline to locate all its operations in T2, this does not impose additional costs on the system as a whole since terminal capacity is not the constraining factor on the airport. Airport capacity is constrained by the runway rather than by terminal capacity.

bmi suggested that the introduction of peak charges would result in the peak passenger group suffering a price rise, in addition to the peak-hour congestion that this group must bear. It added that the existence of inelastic peak hour demand should not result in excess prices being charged to consumers.

IATA reiterated its earlier opposition to the introduction of peak charges. It argued that peak charges would arbitrarily reallocate costs between airlines that have little opportunity to react to these changes given the other constraints and pressures under which they operate.

ITIC argued that peak demand is a natural feature of the air-transport market. Attempts to change this by pricing mechanisms were unlikely to work. It suggested that peak charges would introduce other costs and diseconomies for airlines and passengers.

Differential Pricing

The Commission did not propose to impose differential pricing, although it was satisfied that such a proposal would not conflict with rules concerning abuse of a dominant position (e.g. Article 82 EC). The Commission supported the principle of users being charged different prices for different levels of service. It indicated that the costs of future capital expenditure plans to improve the quality of service in T1 (or T2) would only be included in the RAB if users of the terminal indicated a willingness to pay for the improvements. Where users indicated a preference for lower charges rather than higher service quality, the DAA should seek to meet these requirements.

In response the **DAA** suggested that it would have no ability to charge differential prices. Aer Lingus would not use T2 if it had to pay a higher price at Dublin Airport to its competitors, leading to continued overcrowding at T1. The DAA also raised the issue of the EC’s Article 82 and argued that it would only be completely immune from a legal challenge if differences in prices were based on the absence of any cross subsidy or reflected different levels of service.

The DAA also questioned the use of differential prices in the context of the single till. The long-haul passengers who would be using T2 generate significantly greater commercial revenues than short-haul passengers. The DAA suggested that this logic could lead to lower prices for T2 users.

In respect of the call from certain users for low-cost facilities, the DAA argued that airlines may not represent the needs of passengers using Dublin Airport. The DAA presented research it had commissioned that it suggested demonstrated a uniformity of willingness to pay for service enhancements across all passengers.

In its submission **Aer Lingus** argued that T1 and T2 should be viewed as homogenous terminal capacity and priced accordingly. It stated that T2 is being specified to provide the same quality of service as T1 and that there is no justification for differential prices. The consultation process with the DAA was on the basis of no differential prices between the terminals. Aer Lingus added that if an airline desired a higher level of service it should be possible for that airline to negotiate a price with the DAA.

Ryanair called for the 'user pays' principle to be applied for the T2 project and suggested that T2 users alone should fund higher levels of service. Aer Lingus and other users of T2 should pay for cost of T2. There was no case for requiring Ryanair's passengers to cross subsidise a terminal they will never use.

bmi queried whether the cost of T2 was driven by its size or the service quality. It stated that if the costs were purely size related then there should be a reduction in the allowed costs, whereas if T2 costs were driven by service level then differential pricing should be integrated into the tariff structure.

IATA stated that it does not generally support differential pricing but added that where such a policy is implemented there must be transparency of costs to ensure that the differences relate to differences in costs. It added that all airlines should be given equal non-discriminatory access to low-cost facilities.

ITIC did not support differential prices where there was uniformity of service across both terminals. In relation to low-cost facilities ITIC argued that the desires of airlines for such facilities should not be at the expense of passengers.

<u>Commission's View on Pricing Issues</u>

The Commission's position on these topics remains broadly similar to the views expressed in CP5/2007:

- It will consider introducing trigger prices for major investment projects, including T2 if it is not complete by 2010, at the next Determination;
- It foresees unitising depreciation charges for T2; and
- It does not currently envisage introducing sub-caps requiring peak or differential prices.

The rationale for these conclusions remains as described in the Commission Paper CP5/2007.

The DAA is best placed to manage the risks relating to the completion date for T2. Consequently, the Commission thinks that the DAA should assume the risks associated with the possibility of delay. If a project can be completed ahead of schedule, the Commission would be willing to construct a trigger that allowed the DAA to start collecting higher charges earlier, provided that the project met the needs of users at the earlier date. If a trigger is introduced for T2, the exact definition for when the costs will enter the RAB would be something for consultation between now and the next Determination, although the guiding principle in defining such a trigger will be that it allows the DAA to start collecting revenues once T2 achieves operational readiness.

Arguably a unit-cost approach to depreciation better aligns the costs and benefits to passengers of long-lived assets. For this reason, and consistent with the conclusions it has reached after consulting on the issue during this Interim Review, the Commission is now minded to prefer such an approach over straight-line depreciation. However, the Commission will only introduce such an approach gradually and with consultation, being careful to ensure that switching away from straight-line depreciation does not create cash-flow difficulties for the DAA.

For major capital projects, perhaps the biggest risk for a regulated entity is whether the asset will be included in the RAB. The majority of T2's costs will enter the RAB when it is complete. The fact that the cap on per passenger charges will be recalculated at each Determination reduces the risk that the DAA will over or under recover significantly different amounts to the total cost of the project. Favouring unitisation rather than straight-line depreciation only increases the risk of significant under-recovery if there is a strong possibility of passenger numbers falling dramatically during the life of the asset. The fall would need to be so large that there is insufficient demand to support the charges necessary to recover the remaining costs of the terminal (at later dates the costs yet to be recovered will be higher under unitisation than under straight-line depreciation)[13]. The Commission has not received evidence to suggest that this risk is significant enough to materially affect the DAA's finance risks or overall financeability – if this risk were material, the Commission would not expect the DAA to commence with plans to build a terminal of the size of T2 regardless of the depreciation profile that the Commission proposed.

The Commission will continue to use the building-blocks approach when estimating airport charges. If the calculations generate a cap on charges that could give rise to cash-flow difficulties in the short-term, the Commission would consider varying depreciation profiles (accelerating them). It is assumed that the charges estimated using the building-blocks approach will have already considered possible cost savings. If depreciation profiles were accelerated, the calculation would be net-present value neutral: there is no intention to allow the DAA to collect a duplication of depreciation charges. Nor should it materially affect the allocation of an investment's risks between airlines and the airport. The decision to include an asset in the RAB rather than commit to a 40 year price path for the asset is more relevant when considering the allocation of risk between the parties.

The Commission's proposed approach to unitising the costs of T2 seeks to avoid the need for a step-change in charges if further capacity expansion occurs. The Commission is keen to avoid users paying more at different dates if the level of service received is constant across that time period.

The DAA retains the option to introduce peak or differential charges at Dublin Airport. The Commission considers that both options have merit. On demonstrating demand for expansion, the Commission accepts that an investment should proceed if all users support an investment programme to expand capacity, including an agreement about the programme's costs and implications for charges. The Commission will not automatically include in the RAB proposed investments agreed between one user and the DAA on the basis that there will be no differential pricing.

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[13] See Section 3.3, Commission Paper CP1/2007, for further discussion of the different cost recovery profiles implied by the different approaches to depreciation.

On the possibility of setting peak prices in T2 only, the Commission refers to the evidence it has collected suggesting that T2 appears to be large given its forecast annual throughput. The rationale offered for this is that T2 users will have a very peaked demand schedule. A willingness to pay peak prices would demonstrate that T2 users considered the benefits of being based in a single terminal and having a very peaked schedule to outweigh the additional costs associated with building a larger facility. There has been no evidence presented suggesting that if all users were based in an expanded T1 its capacity would have to increase to handle an additional 4,200 passengers in the busy hour. Nor is there evidence that the additional capacity needs arising when there are two terminals rather than a single large terminal to handle 30mppa would ordinarily justify a facility as large as T2.

The Commission reiterates that it is keen for the DAA to tailor services for users at Dublin Airport so that if different users would prefer different mixes of quality and price, these options should be provided where possible. The building of a second terminal will afford the DAA more opportunity to do this. Airlines should be offered non-discriminatory access to both low-cost and high-cost facilities, when both are available. Plans to spend money upgrading a terminal will need to have the support of users. If T1 users indicate a preference for a lower quality of service and lower airport charges, the Commission will expect the DAA's plans to reflect these preferences. The Commission is willing to consider evidence of a discrepancy between the preferences of passengers and their airlines when assessing development plans at the airport.

3.4 Assessment of Proposed Investment Costs

Table 1 summarises the Commission's draft proposals from CP5/2007 on what it estimated to be the costs required for the projects in CIP2006. The table includes a comparison with the costs provided by the DAA. The Commission's proposals on capital expenditure were informed by the results from analysis undertaken by consultants RRV.[14] The RRV work consisted of both a review of certain CIP2006 project costings (for projects in excess of approximately €5 million), as well as an assessment of T2's size given likely ranges for airport demand going forward.

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[14] See Annexes 7-10, Commission Paper CP5/2007.

	CIP 2006 (DAA)	CP5/2007 (Commission)	Difference
T2 main projects	€607m	€582m	€25m
Other projects	€571m	€535m	€36m
Total	**€1,178 million**	**€1,117 million**	**€61 million**

Table 1: Commission's assessment of CIP costs in the Draft Decision
Source: Page 8, Commission Paper CP5/2007.

The details of the €61 million difference between the Commission's proposals in the Draft Decision relative to the DAA capital expenditure costs in the CIP2006 are set out in Table 2.

	CIP 2006 (DAA)	CP5/2007 (Commission)	Difference
T2 main project contingency (total)	€99m	€74m	€25m
Customs and border protection	€30m	€21m	€9m
Airfield projects	€103m	€86m	€17m
T1X project	€55m	€52m	€3m
Pier D project	€120m	€112m	€8m
Total			**€61 million**

Table 2: Summary of Commission proposals on allowed capital expenditure by broad project grouping
Source: Commission Paper CP5/2007.
Notes: Figures subject to rounding

The Draft Decision also outlined the Commission's proposals on the mechanism for recovery of allowed CIP2006 capital expenditure. For capital expenditure not directly related to T1X, T2 or Pier D the Commission proposed that the cost of these projects enter the RAB once the expenditure is incurred (i.e., in line with the time-table as set out in the CIP2006). The Commission also proposed to depreciate the costs of these projects on a straight-line basis over the lifetime of the assets.

With respect to the recovery of allowed capital expenditure for T2-related projects, the evidence available to the Commission suggested that T2 was larger than might have been expected. Consequently, the Commission proposed a two-box approach, allowing capital expenditure costs for the T2 project to enter the RAB in two stages: €430 million for box one, with depreciation charges commencing once T2 was complete; and the remainder in box two entering the RAB once passenger numbers at the airport exceed 30mppa. Recognising the financial constraints that a significant capital project on the scale of T2 places on an airport's finances, the Commission proposed full pre-funding of financing for T2. Rather that straight-line depreciation, the Commission proposed unitising the capital expenditure costs of T2 over all the potential T2 users for the lifetime of the asset to produce a constant real unit charge over time.

Depreciation charges and the allowed return on capital for T1X would be capped such that they did not exceed forecast incremental commercial revenues associated with the project. In this way, the project would be charges neutral in keeping with the consultation between the DAA and users. For Pier D, the Commission indicated that any additional costs over the amount allowed in the 2005 Determination would be viewed as a cost overrun, and would not be considered until the time of the next Determination.

DAA Response to Draft Proposals on Allowed Capital Expenditure

The DAA provided the Commission with an extensive response to the proposals presented in the Draft Decision. The DAA acknowledged that there were some areas where the Commission's conclusions and its own capital expenditure costs as presented in the CIP2006 were broadly in agreement. However, the DAA also noted some areas of disagreement. Given that the DAA's response to the Draft Decision, including a number of appendices responding to the RRV reports, is available on the Commission's webpage, this summary focuses on the areas of disagreement with the Commission's proposals. Furthermore it focuses on comments that might materially affect the Commission's Decision with respect to the level of capital expenditure to allow in the RAB and how it is remunerated going forward.

The DAA had concerns that the Commission was speculative in its treatment of capital expenditure. It viewed suggestions in the Draft Decision to reduce contingency costs and rely on lower priced tenders as a threat to its financeability.

With respect to the Commission's proposals to disallow €25 million of project contingency costs for T2-related projects, the DAA stated that this was

> *"[m]anifestly unreasonable and inappropriate, and totally ignores the challenges and complexities of the programme in question"*[15]

The DAA questioned the ability of RRV to carry out a meaningful quantitative risk-based contingency exercise on the basis of its lack of expertise in this area. It also rejected RRV's assertion that project costs should be compared with out-turn costs of comparable projects. The DAA argued that such an approach is only relevant for projects with similar risk profiles, "a very unlikely scenario" as "no two projects will ever be constructed in the same site environment."[16]

The DAA argued that the adjustment the Commission had made to reduce the allowance for the Customs and Border Protection project (CIP 7.027) excluded any allowance for fees, planning contributions and the project contingency associated with this project. When these costs are included the project cost is closer to €24 million rather than the €21 million allowed by the Commission. The project cost should also include, according to the DAA, allowances for: works to connect to the T2 baggage system, the construction of 'sterile corridors' connecting to Pier E and alterations to the existing Pier C for vertical escape routes. It is these costs that "underpin the total project budget of €30 million".[17]

The Commission's proposal to disallow €17 million of capital expenditure for 'Airfield Projects' on the basis of recent tenders received by the DAA that were more competitive than cost projections contained in the CIP2006 was deemed inappropriate by the DAA. It claimed that the RRV review of the DAA cost benchmarks indicated that the DAA's CIP2006 costs were within the range given by the benchmarks. It was inappropriate to extrapolate from the fact that one project tender cost appeared to be less than the projected CIP2006 cost that the same will be true of other airfield-related projects. Aspects of the particular project in question (the P2 Bypass Project) meant it was likely to be quite different in terms of project characteristics from other types of airfield-related works; moreover, the costs in CIP2006 for the project 'Taxiway Mike 2' [CIP 6.030] reflect the actual tender return. Therefore the effect of the Commissions proposals was to disallow some 16% of costs, resulting in a situation where recovered costs are "below the tender return"[18]

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[15] Page 44, the DAA (2007) "Response to Draft Decision"
[16] Page 7, Appendix 2, the DAA (2007) "Response to Draft Decision"
[17] Page 45, the DAA (2007) "Response to Draft Decision"
[18] Page 47, the DAA (2007) "Response to Draft Decision"

The DAA claimed that CIP2006's cost estimates for T1X did not include an inappropriate allowance for future inflation of €3m, the Commission's stated rationale for reducing the T1X allowance by this amount. Indeed, the cost for the project in the CIP did not, according to the DAA, include any allowance for inflation. As such, the DAA stated that:

> *"There is […] no basis to support CAR's deduction of €3m from the allowed capital expenditure for this project"* [19]

While the Commission had indicated that the appropriate time to review the costs of the Pier D project was at the time of the next Determination (since an allowance for the project had been included in the 2005 Determination) the DAA was critical of the proposal to disallow approximately €8 million from the CIP2006 costs for the Pier D project. The proposal to disallow €5.3 million of Pier D costs due to the apparent duplication of works in the project with works in the 'Central Immigration - Pier A&D' project [CIP 7.025] was based on an "incorrect assumption, [as] no duplication exists […] the projects are completely separate and subject to separate procurement."[20] On the proposal to disallow approximately €1.7 million of contingency costs for the Pier D Project, the DAA considered that the level of contingency identified was robust and subsequent progress on the project had verified its adequacy and requirement. Finally, the DAA claimed that it was wrong to disallow €0.7 million of contingency costs for the 'Temporary Forward Lounge' [CIP 7.020] on the basis that the project is effectively complete. The project is "not complete and therefore it is still appropriate to hold contingency […] the TFL must yet be dismantled."[21]

The Commission's assessment of T2-sizing issues and the proposed two-box approach are both closely linked. The Commission's proposals in relation to the two-box approach were motivated by concerns as to the robustness of the DAA's demand projections which underlie the planned 75,000 sq/m T2. These concerns were based on evidence presented by RRV in its report on T2 Sizing.[22] The DAA contested some of the evidence presented in this Report.

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[19] Page 46, the DAA (2007) "Response to Draft Decision"
[20] Page 46, the DAA (2007) "Response to Draft Decision"
[21] Page 47, the DAA (2007) "Response to Draft Decision"
[22] See RRV (2007) "Review of Dublin Airport Authority Capital Expenditure Programme (CIP 04): Report No. 4 – Review of the DAA Terminal Sizing", appendix 10 of Commission Paper CP5/2007.

The DAA asserted that the short-time period available to RRV to carry out this work has resulted in RRV adopting a "simplistic overview of the whole project".[23] This meant that "[t]he RRV analysis contains serious misinterpretations and inappropriate conclusions".[24] The DAA cited the following examples:

- Inappropriate criticism by RRV of the peak-day/peak-hour methodology adopted by the DAA;
- RRV, in projecting forward future demand, did not consider the possibility that the airport is already congested; its "simplistic design by ratio approach is not a robust basis for capacity development as it would result in current levels of congestions being designed into the new facility";
- The over-reliance on IMR Solutions' analysis of busy hours, which the DAA had previously identified as having serious methodological deficiencies;
- The use of inappropriate airport comparators to assess the empirical relationship between busy hour flow rates and annual passenger throughput; and
- The use of incorrect assumptions in relation to the analysis of load factors.

Consequently, the DAA strongly disagreed with the approach and conclusions of the Commission's consultants. It argued that the Commission:

> *"should revise its views on the sizing issue and accept either the DAA's analysis is appropriate or that it would be more prudent to accept a figure in the mid-range between the DAA and RRV/AE's [Aviation Economics] analyses."*[25]

The DAA claimed that the proposed two-box approach did not consider the potential cost efficiency arguments for providing more capacity than is initially required. A modular provision of new terminal capacity could result in additional costs such as: setting up site again, re-commissioning building services and baggage systems, disruption to airport tenants and concessionaires, abortive work for external walls to allow modular construction of the terminal, additional capital contributions for service providers and potential loss of scale economies.

The DAA was also critical of the Commission proposal to finalise the structure for the two-box approach during consultation leading to the 2010-2014 price control. The DAA believed that it was unreasonable to expect the company to proceed with an

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[23] Page 50, the DAA (2007) "Response to Draft Decision"
[24] Page 50, the DAA (2007) "Response to Draft Decision"
[25] Page 52, the DAA (2007) "Response to Draft Decision"

investment plan on the scale of the CIP in the absence of a fully worked-out approach.

Notwithstanding the above criticisms on the proposed two-box approach, the DAA also asked the Commission to reconsider the scope of projects included under the approach. The DAA argued that the focus of the two-box approach should only be on the facility that the Commission considers to be too big - that is, the T2 facility, which the DAA costs at €395[26]. Specifically, the DAA believed that the costs associated with Pier E and T2 Additional Projects should not be subject to the two-box approach. For Pier E, the DAA noted that "it is agreed by all users that additional gate served stands are required now, therefore no overcapacity is envisaged for the Pier E facility."[27] The costs included under T2 Additional Projects (€150 million of projects in the CIP2006, of which the Commission proposed to allow €141 million) were, according to the DAA "either not associated with T2 or are required to support the full development programme."[28] As such, they should be excluded from the proposed two-box approach.

__Other Parties' Responses to Draft Proposals on Allowed Capital Expenditure__

Aer Lingus' comments on the capital expenditure proposals in the Draft Decision focussed on the Commission's assessment of the T2-sizing question. Aer Lingus believed that the Commission would be wrong to alter the specification of T2 as specified in the CIP2006. It stated that the

> *"adjustments to T2 proposed by Aviation Economics have the effect of reducing the proposed peak capacity, have not been part of any user consultation and, specifically, have not been agreed by Aer Lingus."* [29]

Aer Lingus also pointed out that the proposed adjustments to the peak hour passenger figure of 4,200 pph ignored the "operational imperatives" of the low-cost carrier model such as that operated by Aer Lingus.

bmi argued that the potential excess costs identified by the Commission in the Draft Decision should not enter the RAB: the busy-hour analysis pointed to over-forecasting on the part of the DAA. On the basis of this busy-hour analysis in the

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[26] Page 53, the DAA (2007) "Response to Draft Decision"
[27] Page 61, the DAA (2007) "Response to Draft Decision"
[28] Page 61, the DAA (2007) "Response to Draft Decision"
[29] Page 1, Aer Lingus (2007) "Submission of Aer Lingus to the Draft Determination on the Maximum Level of Charges at Dublin Airport (CP5/2007)"

Draft Decision and associated reports, which bmi welcomed, bmi proposed "scaling back of T2 to 53,891 sq/m rather than the proposed 74,555 sq/m."[30]

bmi noted that to ensure that T2 is justified it is important that the DAA provide realistic forecasts. Furthermore, the DAA and the Commission should strive to ensure that the price-cap used to justify T2 going forward is based on realistic traffic forecasts. The DAA had provided an unreasonably low traffic forecast. On the two-box approach bmi believed that the 30mppa threshold for box two will be reached quicker than expected. As such, the issue with box two becomes 'when' rather than 'if' the proposed box two capital expenditure will enter the RAB. bmi claimed that this places the risk primarily with the airport users, i.e. airlines.

bmi acknowledged that the DAA should be allowed to benefit from genuine cost savings in delivering capital expenditure projects, but did not believe that unused contingency costs and duplication of costs should be left in the RAB as this could encourage over-budgeting (on contingency costs), and potentially allow for mistakes to enter the RAB (in the case of duplication of costs).

IBEC described Dublin Airport as a severe bottleneck to economic growth and inward investment. It was essential to develop Dublin Airport's second terminal and additional piers, as designed. IBEC stated that the capacity delivered – which must be cost effective – should reflect long-term growth patterns. The Commission's proposals did not promote economic expansion as, according to IBEC, they envisaged construction of a small facility initially with incremental capacity added as and when required at a later date.

ITIC argued for some capacity-related headroom to be built into the proposed T2 at Dublin Airport. It also acknowledged Commission arguments presented in the Draft Decision for deferring recovery of a proportion of capital expenditure costs until traffic numbers are larger (the two-box approach, and unitisation). However, ITIC did not want any such proposals to either delay the delivery or cause a downsizing of T2.

Ryanair believed that the Commission had considered the T2-sizing question in isolation from the capacity of T1, and therefore capacity at the Airport as a whole.

[30] Page 2, bmi (2007) "bmi Response to Commission Paper 5/2007"

Ryanair claimed that this ran contrary to the Commission's primary objective which was the delivery of efficient and economic development of Dublin Airport.

Ryanair believed that the RRV analysis did not acknowledge the true extent to which the DAA is building excess capacity in T2 as it did not fully consider total capacity of both T1 and the proposed T2. Ryanair noted that the DAA is "on record as stating that Terminal 1 will have a departing passenger capacity of 4,800 passengers once [T1X] has been constructed."[31] Ryanair estimated that this would imply an effective annual throughput of passengers at T1 of 25mppa. There was therefore no case for the Commission's assumed 'comfortable capacity' in T1 of 18.5mppa, which is used as part of the unitisation to generate the depreciation profile for T2-related capital expenditure.

Ryanair also commented on the thresholds used as part of the proposed two-box approach to remunerating T2-related capital expenditure. It believed that planning constraints on the existing airport campus of 30–35mppa represented the absolute ceiling on capacity that the two terminals can provide. This implied that T2 could not provide usable capacity in excess of 10mppa, and the DAA should assume any risks of developing T2 to handle demand in excess of this level.

Ryanair was supportive of the two-box approach, but with the following proposed changes to the thresholds and size of the proposed boxes:

- Increasing the 'comfortable capacity' of T1 from 18.5mppa to a level more consistent with existing plans for works in T1, i.e. 25mppa.
- Change the size of box to reflect the Fingal County Council planning guidance, i.e. 30–35mppa.

Ryanair also argued that the following costs should be placed in box two:

- Costs relating to the replication of existing facilities in T1;
- Costs relating to the accommodation of Aer Lingus and its partners in a single terminal, despite available capacity and split of airside operations;
- Costs to accommodate an excessive peak of demand in T2*;* and
- Costs for the provision of facilities to a higher level of service than are needed by and provided for T1 users.

[31] Page 2, Ryanair (2007) "Ryanair Response to Draft Decision on the Interim Review of 2005 Determination on Maximum Level of Airport Charges at Dublin Airport"

Ryanair disagreed with the Commission's assessment that, abstracting from doubts over the proposed design capacity of T2 in the CIP2006 and caveats relating to T1X and Pier D overspend, the vast bulk of the costs in the CIP2006 were reasonable. RRV's analysis of benchmarks only considered the DAA's own benchmarking reports, which included previous the DAA projects, thereby perpetuating any inherent cost inefficiencies. Low-cost facilities were excluded from the benchmarking, and it was not clear how the Jacobs work on low-cost facilities has been used to inform the exercise. Ryanair provided further evidence, based on BAA second terminal costs at Stansted and work undertaken for IATA in relation to a new pier at Edinburgh Airport, that the DAA's proposed costing for T2 terminal and Pier E are significantly above benchmark costs. The use of IATA level of service C as a design parameter "will result in an over-sized and over-specified development and is not appropriate to meeting the needs of users."[32] Ryanair believed that, without a full consideration of these points, it would be inappropriate to provide any indication of whether and how capital costs might be remunerated in future Determinations.

Ryanair stated that many of the concerns expressed with regard to the cost of T2-related investments also applied equally to the costs of other developments. The Commission has failed to exclude the cost of Pier C. According to Ryanair, the DAA is proposing T1X "primarily to reinstate lost retail and catering revenues as a result of the closure of Pier C to enable the construction of T2."[33] Ryanair stated that, given that the capital expenditure associated with such facilities is already in the RAB, users are therefore already paying for it – allowing the costs of T1X at the next price control would mean that users effectively end up paying twice for the same facilities.

UPROAR was critical of the model used by the DAA to derive their traffic numbers because it did not include passenger charges as an explicit exogenous variable.

Commission's Revised Proposals on Allowed Capital Expenditure

Since the publication of the Draft Decision the Commission has considered further whether and how to allow the proposed capital expenditure in CIP2006 to be remunerated. The responses received from interested parties (described above) and

[32] Page 8, Ryanair (2007) "Ryanair Response to Draft Decision on the Interim Review of 2005 Determination on Maximum Level of Airport Charges at Dublin Airport"
[33] Page 9, Ryanair (2007) "Ryanair Response to Draft Decision on the Interim Review of 2005 Determination on Maximum Level of Airport Charges at Dublin Airport"

further reports commissioned from RRV and IMR Solutions (see annexes 1-3) informed this work. The final proposals are outlined below.

In conducting this analysis, the Commission refutes the suggestion that it is too speculative in its treatment of capital expenditure costs or that it is micro-managing the DAA. It also reiterates that it is not the role of the regulator to dictate to the DAA either the scale or scope of the capital investment projects it wishes to undertake. Rather the role of the regulator is to try and ensure that the DAA is incentivised to carry out investments at Dublin Airport in an economically efficient manner. The costs of such efficient investment can then be remunerated through regulated airport charges.

Table 3 shows the Commission's final assessment of the CIP2006 costs. The first column shows the cost estimates in the CIP2006 from October 2006, the second column shows the proposals from the Draft Decision, and the third column presents the Commission's final proposals.

	CIP 2006 (DAA)	**CP5/2007 (Commission)**	**Final Proposal (Commission)**
T2 Main Projects	€607m	€582m	€582m
Other Projects	€571m	€535m	€556m
Total	**€1,178m**	**€1,117m**	**€1,138m**
Difference to CIP2006		**€61m**	**€40m**

Table 3: Summary of Commission's assessment of CIP2006 costs
Source: Page 8, the DAA CIP2006, Commission Paper CP5/2007 and Commission calculations.

Following responses to the Draft Decision, and in particular clarification on several project specifications and costs from the DAA, the Commission has increased its assessment of costs for the projects as specified in the CIP2006 from €1,117 million to €1,138 million, an increase of €21 million. This increase is accounted for by upward revisions in the Commission's estimates of the costs for the T1X, Pier D and airfield projects for the reasons outlined below. The change in the allowed capital expenditure for airfield projects will affect the level of future price caps. The Commission will review the case for allowing the DAA to recover any cost overrun associated with the Pier D project at the time of the next Determination. The Commission intends that T1X costs should not affect the price cap.

The DAA has provided evidence to support its contention that the T1X project costs did not include an inappropriate amount for future inflation. The Commission therefore proposes to accept the full costing for T1X as outlined in the CIP2006 of €55 million.

The Commission accepts that that its review of CIP2006 should not have concluded that the Pier D estimates were almost €8 million too high; it now believes that the estimates are €2.3 million too high. The Commission has revised its estimate of Pier D costs up €5.3 million because it is now satisfied that there is no duplication of costs, in particular works relating to CIP7.025 'Central Immigration – Pier A&D'. The DAA has provided further information, including detailed drawings. The conclusions reached in the Draft Decision to reduce project contingency allowance remains. The Commission notes that RRV's response to the DAA's comments describes the temporary forward lounge as being effectively complete and the agreed final account for the project *includes* a costing for demolition work. And while the methodology used for estimating contingency costs is not disputed, the Commission questions the underlying numbers and the evidence used to populate the DAA's risk register. The DAA did not provide further evidence in this respect to counter RRV's assertion that a contingency provision of 12% for a project which is fully designed, tendered and well into the construction phase represents a relatively high allowance.

For airfield projects, the Commission proposes to disallow €4 million of the costs, rather than the €17 million it proposed to disallow in the Draft Decision. The DAA has provided, following an information request, tender receipts for six additional projects. The out-turn costs for tendered projects is €76 million, €3 million less than forecast in CIP2006. The Commission believes it is better to base its decision on this additional evidence, rather than relying solely on the overall estimated cost savings derived from one particular airfield project.

The Commission continues to believe that the costs for project CIP7.027 (Customs and Border Protection) are €9 million too high. The RRV benchmark figure for this project *includes* fees and a contingency provision. It is reasonable to expect that provisions for cost items such as T2 baggage systems, construction of sterile corridors and Pier E escape routes should all be included in any cost estimate that is based on a cost per square metre for T2, or general benchmarks for terminal buildings. Moreover, the DAA has not provided further substantiation or details on these issues.

Consistent with the Draft Decision, the Commission has decided to disallow €25 million of contingency costs for T2. If this sum were allowed, it would mean contingency costs were in excess of 20% of construction costs, a level of provision that the Commission considers too high. It is outside the range RRV has indicated it would expect for a project at the planning application stage. RRV suggested that a typical level of project contingency, including a design development allowance, would be 15% in the early design stage, falling to 10% for the construction phase. RRV's assessment of the DAA benchmarks indicates that construction costs for T2 would be 19% above the benchmark calculation if all contingency costs were included.

The Commission also notes RRV's response to Ryanair's criticism of its assessment of the DAA benchmarks.[34] Ryanair argues that the RRV work only considered the DAA's own benchmarking reports, which includes previous the DAA projects and therefore potentially includes any cost inefficiencies that may have occurred in the past. The RRV assessment was not based solely on the DAA cost benchmarking reports. RRV reviewed all the cost information provided by the DAA, but the assessment and comments in the RRV report are based on the RRV team's specific relevant experience of comparable works. Of the 27 projects which were used to assemble benchmark information for the CIP2006 projects, only five of these were the DAA's own projects.

The Commission agrees that the costs of T1X are high relative to benchmark evidence. If the DAA were not proposing to recover all of these costs from higher commercial revenues, the Commission might have concluded that the costs were excessive and revised the allowance down to a benchmark level. However, given the proposed recovery of T1X costs outlined below, the Commission has focussed on RRV's review of the actual costs.

On the use of the IATA level of service C as a design parameter, the Commission notes RRV's comments on how this will have a limited effect on the costs of building a new terminal. Moreover, RRV has suggested that in some other instances the

[34] Page 6, Annex 1.

proposed new terminal has used design parameters that are smaller than might otherwise have been expected.

Commission's Proposals on Recovery of Allowed Capital Expenditure

In addition to considering the level of capital expenditure that is necessary given the DAA's planned investment projects, the Commission has also given careful thought to whether and how these costs should be recovered. The Commission is keen to protect the interests of users while allowing the DAA to recover efficiently incurred costs that meet the needs to users. For T1X and T2, the Commission has concluded these objectives would not be met if the Commission simply included the costs in the RAB and applied straight-line depreciation.

Table 4 summarises the proposed treatment of the T2 Main Projects costs. The depreciation of all of the assets in the RAB will not commence until T2 is operational. In a change from its Draft Decision, the Commission now proposes to exclude from the two-box approach the costs of Pier E (including associated apron remodelling), other works (including 'Enabling works', 'Kerbs/roads' and 'Energy Centre') and T2 Associated Projects.

	CIP 2006 (DAA)	**Final proposal (Commission)[3]**	**Two-box treatment**
T2 facility	€395m[1]	€379m	Yes
Pier E and Apron remodelling	€111m[2]	€107m	No
Other works in T2 Main Projects	€100m	€96m	No
Total T2 Main Projects	**€607m**[2]	**€582m**	

Table 4: Proposed RAB-treatment of T2 Main Projects

Notes: Calculation of totals subject to rounding. (1) Figure provided by the DAA for costs of constructing T2 'facility', DAA Main Response to Draft Decision, page 53. (2) Page 2, Davis Langdon PKS Cost Plan No. 1 on Terminal 2 & Pier E, Dublin Airport, 1 September 2006. (3) All figures reduced on a pro-rata basis according to the ratio of the disallowed construction contingency cost proposed by the Commission (€25m) to the total cost of T2 Main Projects (€607m).

The Commission intends to retain the proposed two-box approach, albeit for a smaller box two than proposed in the Draft Decision. The Commission continues to believe that the planning parameters employed by the DAA to size T2, in particular the projected 4,200 passengers departing in the busy hour, is unusually large. It has not been convinced that there is a case for requiring all airport users to pay for the costs of such a large facility from its commencement. The DAA should assume some of the risk that the terminal is too large.

Annex 2 includes RRV's response to criticisms of its analysis of T2's sizing. RRV's conclusion remains that T2 is large, and it stands by its alternative sizing estimates for a facility of between 50,980 sq/m and 58,262 sq/m (using the DAA's own planning parameter for processing passengers in the busy hour of 17.6 sq/m). RRV's top-down analysis of T2 indicates a busy hour departing rate of between 2,897 and 3,310 passengers (depending on whether 70% or 80% of Aer Lingus' expected Dublin-based fleet depart in the morning busy hour). The Commission rejects the suggestion it should merely accept the conclusions of the DAA and its consultants because RRV has had insufficient time to conduct its analysis. If all airport users are to fund investments, then the DAA needs to provide justification for the costs; the Commission will be failing it its duty to protect the reasonable interests of users if it were to allow the extra costs associated with building a larger terminal without evidence that it is justified by the needs of all airport users. The DAA has failed to provide such evidence.

The Commission has accepted the DAA's contention that the costs of Pier E and other T2 works should be outside the scope of the two-box approach. The argument that these costs would be of a similar scale, even if T2 were smaller, is persuasive. Therefore the Commission proposes that only the €379 million of allowed T2 main projects costs relating to the facility itself should be subject to the two-box approach, with €278 million in box one and €101 million in box two. The mid-point of the two RRV estimates of T2-sizing (50,980 sq/m and 58,262 sq/m) divided by the DAA's proposed sizing (74,555 sq/m) is 73%. This is the proportion of T2 costs that the Commission will include in box one.

The threshold before box two enters the RAB has been increased to 33mppa. This is because box two is smaller, reducing financing concerns, and the Commission's estimate of T1's capacity was based on studies conducted prior to recent capacity-enhancing projects in the terminal referred to by Ryanair.

Despite the suggestion in a submission received, the Commission does not currently propose to introduce a third box. If An Bord Pleanala attaches conditions to the

DAA's planning applications the Commission will provide further guidance on how it proposes to treat such conditions in future determinations, should the conditions have the potential to affect materially the DAA's ability to recover the costs of the investment or impose additional costs on the DAA or users. The Commission's decision to allow the costs reviewed in CIP2006 does not imply a commitment to allow other capital expenditure, including costs for projects that the planning authorities may require.

Apart from the T2 projects, the treatment of which is described above, the Commission concluded that €556 million of 'Other Project' costs were reasonable estimates of the costs. Of this, €31 million relates to the Pier D project overspend.[35] The Draft Decision outlined the Commission's proposal to treat the increase in Pier D Project costs as overspend. As such, this €31 million will only be considered for inclusion in the RAB as part of the consultation for the 2010–2014 price control. The Commission does not at this stage make *any* commitment to revise the previously allowed €86.7 million Pier D project costs.

A further €55 million relates to T1X. While the Commission will add this to the RAB if the DAA proceeds with the project, the Commission still intends only to offset the costs of T1X with demonstrated increases in commercial revenues accruing from the project. The project should be charges neutral. The increases in commercial revenue will have to be relative to current trends; T1X has not been presented as a cost of the T2 project designed to recover the opportunity cost of lost commercial revenues and therefore has not been considered in this context by the Commission.

For the remaining €470 million, the Commission proposes to allow €329 million to enter the RAB over the 2006–2009 period, as and when capital expenditure costs are incurred (i.e. in-line with timeframe as outlined in the CIP2006 plans). Another €141 million of capital expenditure, which relates to 'T2 Associated Projects', will enter the RAB once T2 is operationally ready.[36] The Commission has not included the costs of these T2 Associated Projects in the two-box treatment of T2. This

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[35] The 'Pier D Project' as referred to by the Commission, consists of CIP projects CIP 7.012 (Pier D) and CIP7.020 (Temporary Forward Lounge).

[36] 'T2 Associated Projects' includes the Temporary Forward Lounge (Phase 2), Utilities Reconfiguration, Customs and Border Protection, Landside Roads Reconfiguring, Short-term Carparking and Programme Management. See Annex 11 of Commission Paper CP5/2007 for precise details.

explains part of the reduction in box two relative to the Draft Decision. The Commission has accepted that many of the projects are required as part of the airport general development programme and do not relate directly to the size of T2.

The Commission proposes to allow €1,107 million of the DAA's capital expenditure costs to receive a regulated rate of return on capital from when it is incurred. This allows for full pre-funding of financing costs for capital expenditure that is deferred from entering the RAB until T2 is operationally ready, and the subsequent second box. To ensure the appropriate incentives, the DAA will not receive financing costs for box one after 2009 should T2 not be operationally ready; nor will the DAA receive financing costs for box two after 2018 should demand not have exceeded 33 mppa by then. All costs will be indexed to the consumer price index to control for the effects of inflation.

Other than T1X and T2 projects (including the costs of T2 Associated Projects), the capital expenditure allowed into the RAB will be depreciated on a straight-line basis. T1X's treatment has been discussed above. Depreciation of capital expenditure relating to T2 will be subject to a unit-cost approach. The calculations will assume that box two eventually enters the RAB (although this sum will only enter the RAB if passenger numbers at the two terminals exceed 33 million in a year).

3.5 General Approach to Regulation

Although the Commission indicated in its Draft Decision that it was outside the scope of the Interim Review to determine the cap on airport charges that will apply after 2010, there were nevertheless a number of comments from parties relating to how the Commission might treat various factors likely to influence future determinations.

Operating Expenditure and Commercial Revenues

The DAA wanted the Commission to adopt the DAA's projections for net operating expenditure for 2010–2014. It contrasted the Commission's decision to use updated traffic forecasts with the Commission's continued use of estimates of operating costs and commercial revenues that date back to September 2005. As the DAA's projections differ from the Commission's in relation to operating costs, commercial revenues and assumptions regarding dividend policy and liquidity policy, the DAA wanted the Commission to make a policy statement confirming its position on remunerating properly incurred costs. The DAA felt this would provide clarity that future determinations will continue to provide sufficient remuneration to cover the capital and operating costs incurred by the DAA.

The DAA argued that its forecast increases in operating costs should have been included by the Commission when considering prices after 2010. The Commission's approach only allowed for increases directly proportional to traffic volumes, whereas it should have included increases such as the additional costs of new security regulations, increased customer service staff, increased retail space, and increases in insurance and other rates. The DAA stated that the Commission's retail revenues assumptions have not been revised to take account of increased car-parking revenues, increased commercial space in T2 for retail and property, and increased passenger numbers. The DAA used the Commission's model to estimate airport charges for the period 2010-2014 based on the DAA's forecast operating costs and commercial revenues, and calculated an average charge of €9.04.

Failure to revise airport charges after 2009 to reflect the DAA's forecast net operating costs would, the DAA argued, threaten its financeability. The average FFO:debt ratio would be substantially below 15% if average airport charges were €7.75 (as indicated in the Executive Summary of CP5/2007), given the DAA's forecast of net operating costs.

Capital Expenditure after 2009

The DAA wanted reassurances about the type of remuneration scheme that will be in place from 2010. It argued that the Draft Decision contained a number of methodological changes, and that the prospect of further regulatory innovations meant the Commission had increased the regulatory risk facing the DAA. The DAA sought clarification on whether the Commission might use trigger pricing or unitisation for approximate €800 million capital expenditure in the CIP that has not yet been reviewed but which is planned for post 2009.

At the next Determination, Ryanair requested that the Commission claws back the financing costs of T2, the costs of Pier D and other projects which compare unfavourably with low-cost developments elsewhere in Europe, and €150m for the costs of Pier C (which will cease to be operational if the current T2 proposals go ahead).

Ryanair stated that it is inappropriate at this stage to be signalling prices for the next price control period, particularly when the illustrative prices in the Draft Decision included "substantial costs for non-T2 projects, the details of which are not in the CIP and upon which users have not been consulted at all."[37] However, it did argue that the resolution of many of the issues raised in its response should not be left until 2009 to be resolved. This was necessary because of the likelihood of pre-funding of financing costs for potentially inefficient and unjustified investment in T2 prior to 2009; and because of the lack of clear signals in the Draft Determination that, if the DAA proceeded with `inefficient investment' then it did so "entirely at its own risk."[38] Resolution of these issues was required to prevent the DAA from engaging in regulatory gaming going forward.

Ryanair recommended that airport charges should be based on capital projects that meet the reasonable requirements of users, following proper consultation. Ryanair argued that the DAA should not be allowed to recover the €400m it intends to spend on T1, especially given that the DAA plans to reduce the terminal's capacity.

Risk and the Cost of Capital

The DAA believed that the sensitivity tests undertaken by the Commission are only partial, and highlight the risks of the financial ratios deviating from investment-grade levels. The DAA gave the example that a lower cost of capital and an unexpected shortfall in traffic volumes could lead to financial ratios well below financeability thresholds. Statements that the Commission will seek to set airport charges such that the DAA can realise an investment grade nevertheless leave the DAA exposed to the risk that there will be a fall in traffic volumes after the Determination.

The DAA asked the Commission to ensure that the cost of capital allowed fully reflects the level of risk facing the DAA and is increased where risks increase. The DAA suggested that the additional risks that the Commission proposes allocating to the DAA in CP5/2007 should be a factor when considering the appropriate cost of capital. It referred to the 2003 BAA price control review which included a 0.25%

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[37] Page 11, Ryanair (2007) "Ryanair Response to Draft Decision on the Interim Review of 2005 Determination on Maximum Level of Airport Charges at Dublin Airport"

[38] Page 11, Ryanair (2007) "Ryanair Response to Draft Decision on the Interim Review of 2005 Determination on Maximum Level of Airport Charges at Dublin Airport"

premium on the cost of capital to reflect the increased commercial risks associated with building T5. An increase in the cost of capital was seen as a means of improving the DAA's financial viability.

The DAA stated that it would be in the interest of users for the Commission to affirm its commitment to reducing regulatory risk, as this would improve financeability. It sought confirmation that the Commission does not intend to divert away from the building-blocks mechanism, and wanted the Commission to outline explicitly its intentions and planned methodologies to reduce regulatory risk.

IBEC called on the Commission to provide clarity on the funding mechanisms that will be available for future price controls. Such clarity, IBEC argued, is essential for acquiring third-party financing for the investment in Dublin Airport.

Commission's Future Approach to Regulation

The Commission continues to believe it would be inappropriate (and outside its statutory remit) to use this Interim Review to finalise the cap on airport charges that will apply after the existing Determination ends. Nevertheless, the Commission is happy to provide clarification to parties about how it intends to approach specific issues going forward, subject at all times to the legal framework.

The building-blocks approach remains the Commission's preferred method for setting a price cap. A review of all the constituent parts – operating and capital expenditures, the RAB rolled-forward, commercial revenues, the cost of capital, and passenger volumes – will be undertaken, and the results presented for interested parties to comment on, in time for the next Determination. The Commission will also have regard to its duty to enable the DAA to operate Dublin Airport in a sustainable and financially viable manner: should the building-blocks approach generate a price path that would not – in conjunction with all relevant obligations and objectives – enable the DAA to operate Dublin Airport in a financially sustainable manner, the Commission will address this matters by adjusting the calculation leading to the price cap.

The Commission accepts that its model generates a higher average price cap if using the DAA's forecasts for net operating costs. (The Commission estimates that the average price cap reported in CP5/2007 would have been €9.12, higher than the DAA's estimate of €9.04.) At this stage, the Commission has not formed a view on the reasonableness or otherwise of the DAA's forecasts for operating costs or commercial revenues.

The Commission also accepts the contention that the price cap would be lower if, all else equal, it excluded a large portion of the DAA's post-2009 capital expenditure plans. Again, the Commission has not formed a view on the appropriate level of capital expenditure to allow for after 2009. The Commission has previously stated that if proposed investments in T1 do not meet the needs of current and prospective T1 users, then it will not increase airport charges to fund such projects; the Commission will only allow an increase in airport charges to fund efficient investments that are necessary to meet the requirements of current and prospective users of the airport. A forthcoming guidance note on capital expenditure will discuss further the Commission's preferred approach to considering capital investments by the DAA (and the Irish Aviation Authority), including how consultation with airport users might influence the Commission's decision.

Issues relating to the claw back of the costs associated with Pier C have been well documented, most recently in the Commission's response to the Appeal Panel, CP5/2006. In that Decision, the Commission restored the write down of Pier C to the RAB as the alternative was not considered to be the most efficient means to incentivise the DAA's capital investment efficiency. Similar considerations will govern decisions relating to possible clawbacks for Pier D costs or T2 pre-financing costs.

It is the intention of the Commission that when possible it will signal in advance of projects proceeding whether and how it proposes to allow the costs of major projects to be recovered. The Commission does not rule out the possibility of using triggers or unitisation, or other approaches, where the Commission concludes this will help it realise its statutory duties. Any approach adopted would seek to enable the DAA to finance projects needed to meet the reasonable requirements of airport users

All relevant risks will be considered when the Commission assesses an appropriate cost of capital to allow at the next Determination. For the existing Determination the Commission has erred on the high side because of the substantial investment needs at Dublin Airport.

The Commission recognises that its decisions affect the level of risk that the DAA is exposed to, and will estimate the allowed cost of capital accordingly. While the

Commission is keen to minimise the "regulatory risk" that the DAA faces, there are commercial risks that the Commission thinks the DAA should assume, generally because there are risks that the DAA is best placed to manage (e.g. the time to complete a capital project).

Standard and Poor's (S&P) identified three risk factors facing the DAA when placing it on negative credit watch

- Uncertainty about the price cap in 2005;
- Uncertainty about the operation of T2; and
- Uncertainty about the demerger into three separate airport companies.[39]

This Interim Review should have removed some of the biggest uncertainty concerning the next price cap, since it signals what proportion of the DAA's large capital expenditure programme between now and 2009 that the Commission intends to include in the RAB at the time of the next Determination. This, combined with a commitment to continue using the building-blocks approach, should convince investors that the Commission intends to allow the DAA to set charges to recover all reasonably incurred costs.

The other two risks identified are outside the direct control of the Commission. Uncertainty about the operation of T2 is one reason why it would be unwise for the Commission to decide now on what level of operating costs to allow the DAA post 2009. The Commission will seek guidance from the Department of Transport on when and how it envisages determining the operating arrangements for T2; at the appropriate time the Commission will consult on how these proposals might affect its regulation of the DAA's cap on airport charges.

3.6 Financeability

In its Draft Decision the Commission included an entire chapter addressing the issue of financeability. Most of the comments the Commission received relating to this issue have already been addressed in this Report, including the material on the Commission's general approach to regulation. This reflects the fact that it is specific policy decisions that affect whether the DAA will be able to operate Dublin Airport in a sustainable and financially viable manner. Nevertheless, the Commission thinks it will be helpful to include a short subsection dedicated to this issue.

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[39] S&P (2005) "Commentary Report. Credit FAQ: Dublin Airport Authority PLC"

Parties Views on Financeability

Most of the comments relating to financeability were from the **DAA**. Aside from points previously addressed in this Report, the DAA made a number of additional observations relating specifically to financeability:

- the Draft Decision had not addressed the risk of higher costs in the future – either the costs of construction inflation exceeding CPI or potential costs relating to the Metro;
- there might be a perception on the financial markets that the Commission had used the DAA's improved financial position to opportunistically introduce pricing policy changes;
- the DAA's equity providers would reasonably conclude that its equity return was threatened if the Commission's persisted with assuming no dividend payments until 2014 in it modelling;
- the headroom available to the DAA was reduced if the no dividend payments were allowed for in the modelling; and
- the Commission assumed cash balance was inadequate in the context of the overall debt level of the group, seasonality and other factors that affect liquidity.

With a view to affirming a commitment to reducing regulatory risk, as perceived by the DAA and, it argued, possibly by lenders, the Commission could publish a Regulatory Policy Statement similar to that published by CAA in the UK. In a similar vein, the DAA requested that the Commission provide further clarity on the remuneration mechanisms that will be employed in the future with respect to any post-2009 (allowed) capital expenditure.

The DAA argued that the timing mismatch between it incurring the debt finance necessary to fund T2 and the remainder of CIP2006 and the yet to be determined financing mechanism would inevitably lead to the DAA losing its single A credit rating. This was likely to prevent it from accessing the bond markets prior to the next regulatory period, forcing it to rely on bank financing. This was a less attractive option, because of restrictive covenants on the DAA; short-term credit and additional refinancing costs; and a mismatch of asset lives to debt maturity restricting the DAA's ability to reduce refinancing risks.

The DAA felt that should the final proposals include a calculation of illustrative prices for the 2010–2014 price control period, it would "alleviate the difficulties for financeability and ratings assessment"[40] referred to by the DAA in its response, if these illustrative prices reflected assumptions in the DAA's own financial model.

As described on Section 3.3, both **bmi** and **Ryanair** questioned whether it was appropriate to accelerate the depreciation profiles of assets if the DAA encountered financial difficulties.

Restatement of Commission's View on Financeability

One of the Commission's statutory objectives is to enable the DAA to operate and develop Dublin Airport in a sustainable and financially viable manner.[41] During both the consultation on the September 2005 Determination and the current Interim Review, the Commission has given this objective careful consideration. The Draft Decision reaffirmed the Commission's September 2005 position as follows:

- The Commission seeks to enable the DAA to maintain an investment grade for its debt for the purposes of operating Dublin Airport, and is satisfied that an investment grade is sufficient allow the DAA adequate access to funds;
- This does not imply that the Commission must act in such a way as to ensure the single-A (S&P) credit rating of the DAA.
- In setting the price cap for a given determination, the Commission is keen to provide a solid foundation for lender confidence.
- This does not imply that the regulatory regime, and associated price cap, will protect lenders against general business risks.
- In assessing the financial viability of the DAA, the Commission has relied on an analysis of several financial ratios, notably the FFO:debt ratio, one of the financial ratios used by S&P in rating the DAA Eurobond.
- The Commission also recognises that the analysis of financial ratios only provides a partial picture of the overall financial health of a business. With respect to the DAA, and, in particular looking forward, there are a number of other key factors that will impact on the financial health of the company, including: the regulatory regime itself, level of market dominance, ownership structure and the strength of the Irish economy.

[40] Page 30, the DAA (2007) "Response to Draft Decision"
[41] Article 22(4) State Airports Act 2004.

This continues to represent the Commission's thinking on enabling the DAA to operate Dublin Airport in a financially viable manner. The Commission will also continue to have regard to its other statutory objectives: to facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and future prospective users of Dublin Airport; and to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport.

With respect to the Commission's assumptions on dividends in the financial modelling, the Commission notes that the DAA is required by its shareholder to build T2 to the current timetable. The shareholder is therefore aware of the financial pressure this places on the DAA. The Commission does not accept that in order to show a commitment to dividends in the future it must commit to allowing a dividend payment in the financial modelling for the 2006–2009 period. The Commission's modelling shows significantly more headroom in the DAA's finances once the investment peak due to T2 is over and passenger numbers begin to reach the levels anticipated by the DAA. Given the shareholder's role and discretion in setting dividends policy, it would not be consistent with the Commission's statutory objectives to protect the reasonable interests of current users of the airport to set higher changes just to allow the shareholder to withdraw equity.

The Commission rejects the DAA's charge of regulatory opportunism. The remuneration mechanism for T2 have been described, set out for consultation and refined, all prior to commencement of the DAA undertaking the project. In developing the proposals, the Commission has had regard to all of its statutory objectives. It will continue to do so when considering future investment plans. The Commission is keen to provide clarity to all parties in advance of the investment occurring how the Commission intends to treat such capital expenditure in future Determinations.

At the same time, the Commission remains committed to the fundamental building blocks of the required revenue calculation: a RAB-based approach with a return of and a return on capital in the RAB. The proposed introduction of triggers and unitisation for future capital expenditure do nothing to alter the fundamental building-blocks mechanism, nor the Commission's commitment to it.

The Commission places considerable value in establishing and maintaining a reputation of regulatory certainty and clarity, while at the same time striving to satisfy its three main statutory objectives as circumstance evolve. It would not be in the interests of airport users or the DAA if there was a perception that the Commission was minded to overturn commitments to allow the DAA to recover costs that the Commission had previously indicated would be included in the RAB.

This Interim Review has afforded the Commission an opportunity to provide a clear indication about what capital expenditure over the next two years will enter the RAB, when it will enter the RAB, and how it will influence subsequent charges. To summarise: subject to output and demand triggers, the Commission proposes to include €1,107 of the €1,178 CIP costs into the RAB.

	Capital Expenditure Allowed	**Trigger**
CIP Projects not Related to T2 or Pier D	€384m	No trigger
T2 Associated projects	€141m	T2 ready for operations
Non-terminal T2 Main Projects (Pier E and Enabling works)	€203m	T2 ready for operations
T2 box 1	€278m	T2 ready for operations
T2 box 2	€101m	T2 ready for operations Total demand at the airport exceeds 33mppa
Total (subject to rounding)	**€1,107m**	

Table 5: Commission proposals on Capital Expenditure entering the RAB.

For reasons outlined elsewhere, the Commission has opted not to present any illustrative prices for the 2010–2014 period. The Commission acknowledges comments from both Ryanair and the DAA regarding the mixed signals that such illustrative prices may generate. The Commission also feels that there is sufficient uncertainty around a number of key parameters in advance of the 2010–2014 review to make the usefulness of such illustrations questionable. In particular, the Commission acknowledges criticisms from the DAA regarding the net operating expenditure forecasts used for these illustrative price projections. The nature of the building blocks mechanism employed by the Commission, along with the resetting of price-caps on a five-yearly basis, means that the regulatory price cap can respond at the time of each price review to changes in underlying cost drivers, such as (net) operating expenditure. If, by the time of the next Determination, the Commission were satisfied that the DAA's efficient net operating expenditure performance was in-line with the DAA's current projections, the cap on airport charges would be correspondingly higher.

4 COMPLIANCE WITH LEGAL REQUIREMENTS

4.1 Statutory Objectives

Section 33(1) of the Aviation Regulation Act 2001, as substituted by Section 22(4) of the State Airports Act 2004, states the three objectives that the Commission must follow when making a determination. This Decision complies with those objectives, and the Commission will comply with them when issuing its next and subsequent determinations.

(a) ***to facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and prospective users of Dublin Airport**.*

(b) ***to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport**.*

(c) ***to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner**.*

Economic efficiency continues to be the driving principle in the Determination, as it was for the first Determination in 2001 and the subsequent Review in 2004. The Commission has not varied its approach in this Review.

All the statutory objectives must be read together and in light of each other. The comments made by the Commission in the Determination of September 2005 in relation to its statutory objectives, stand. They are not re-capitulated here.

The incentives built into the prevailing price cap are designed to encourage the regulated entity to make efficient decisions regarding how much to invest. In this manner the Commission seeks to achieve statutory objective (a). In this regard the Commission, for the purposes of this Review, has had regard to the DAA's revised capital investment programme CIP2006. As a result of the decision arising from this Review the Commission is satisfied that those incentive effects remain to facilitate the efficient and economic development and operation of Dublin Airport which meets the requirements of current and prospective users.

Within the context of the Review the Commission is satisfied, having regard to financial modelling of the effects of CIP2006 on Dublin Airport Authority's operation at Dublin Airport, that the extra revenues accruing from the increase in passenger numbers above forecast almost exactly offsets the increase in allowed costs. Since the increase in proposed capital expenditure was partly motivated by the increased passenger numbers, it seems logically inconsistent to calculate a revised charge based on an out-of-date passenger forecast while revising upwards allowed capital expenditure motivated by higher passenger numbers. In this regard the Commission believes it continues to achieve statutory objective (b). This Decision does so by first providing that current user interests are protected: while development is encouraged current users do not pay increased airport charges now for infrastructure that will not come into service until after this regulatory period. Secondly the reasonable interests of future users are protected in that development of infrastructure that they will require is encouraged.

The Commission has recognised in making this Review that deferring the recovery of investment costs of the scale and scope needed to fund the CIP2006 may affect the financial viability of the DAA. It has carefully considered various financial indicators, including those that debt ratings agencies consider when rating a company's debt, in particular the DAA's FFO:debt ratio. Having updated the Commission's 2005 financial model to consider changes in the interim, the Commission is satisfied that the FFO:debt ratio should remain above 15% for the remainder of the current regulatory period, even allowing for the proposed additional capital expenditure the DAA proposes to undertake before 2010. The DAA has identified a 15% FFO:debt ratio as the minimum necessary to maintain its investment grade. In addition the Commission analysed the effect of projected changes in the DAA's net operating costs. The prevailing price cap already provides for a rate of return on the assets in the RAB, depreciation thereon and a revenue stream form airport charges. Having considered various DAA financial indicators in light of CIP2006 and the revenue streams available to the DAA from the prevailing price cap, the Commission is satisfied that the price cap on airport charges, unchanged in this Review, enables to the DAA to operate and develop Dublin Airport in a sustainable and financially viable manner for the remainder of the period of the Determination thereby achieving statutory objective (c).

4.2 Ministerial Direction

The two Ministerial Directions relevant for the purposes of this Interim Review were published as annexes to the Draft Decision.[42]

The Commission is satisfied that it continues to comply with the 2005 Direction. It is satisfied that its conclusions will enable the DAA to add additional capacity at Dublin Airport in an efficient and timely manner. It has considered the implications for sustainability and financial viability of the capital expenditure programme for the DAA and is satisfied that the DAA will be able to finance the programme. Moreover, the existing Determination makes sufficient allowance to meet the financing needs during the current Determination period, while the Commission's proposed approach to CIP2006 will allow the DAA to continue work on meeting the capacity needs of prospective users after 2010.

The Commission has complied with the 2007 Direction in the following manner. It has made a Decision that provides for infrastructure capacity increases in line with growth in air services at Dublin Airport, as sought by the National Development Plan 2007-2013. The Commission has also comprehensively reconsidered the sustainability and financial viability implications of the capital expenditure programme, and in particular the impact of providing a second terminal. As a result, the Commission is fully satisfied that the DAA would be able to fund its proposed investment programme.

Concerning the restructuring of the State Airports, which was also referred to in the Minister's 2007 Direction, the position remains as it was at the time of the 2005 Determination, and thus the proposals arising from the Interim Review also comply with the Minister's direction in regard to the restructuring of the State Airports.

4.3 Statutory Factors

The Commission also has to have due regard to a number of other factors. It has complied with this requirement in the following way.

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[42] See annexes 2 and 3, Commission Paper 5/2007.

(a) ***the restructuring including the modified functions of Dublin Airport Authority.***

This statutory factor does not have to be taken into account until Cork and Shannon Airport Authorities are vested with ownership and management of their respective airports. Consequently it has not been addressed for the purposes of the Review.

Reference to restructuring in the 2007 Ministerial Direction is addressed above.

(b) ***the level of investment in airport facilities at Dublin Airport, in line with safety requirements and commercial operations in order to meet the needs of current and prospective users of Dublin Airport****.*

The Commission's view remains that as airports are capital-intensive businesses, it is necessary that their economic regulation be consistent with a level of investment in facilities that allows the needs of users to be met. The Government Aviation Action Plan, with its emphasis on the Commission's independent role in reviewing the cost of investment at Dublin Airport, lends the Commission, in its view, support in pursuing a high-powered incentive strategy towards the DAA's investment programme.

The Aviation Action Plan announced a policy approach, specifically in relation to T2 at the airport. It stated that in sanctioning T2, the Government has approved a triple safeguard to ensure maximum efficiency and cost effectiveness of T2. The three safeguards are:

Consultation: T2 will be designed to meet the requirements of airlines servicing Dublin Airport. To this end, the DAA will consult in detail with the relevant airline operators

Verification: Final specifications and costings of T2 will be independently verified by aviation experts

Regulation: In setting airport charges, the Commission for Aviation Regulation in its independent statutory role will ensure that charges reflect costs appropriate to the building of an efficient terminal.

In this regard the Commission has taken account of the outcome of the Boyd Creed Sweett review of the DAA's T2 costs and in addition made its own assessment of CIP2006 costs informed by the work of various consultants whose reports were published as annexes to CP5/2007.

As stated in the Determination, an assessment of the DAA's capital expenditure programme and its efficiency is a central element of the economic regulation of Dublin Airport. Consequently, it is necessary that the DAA's investment plans be carefully scrutinised as to their timing and efficiency.

To approach this task based on an uncritical adoption of the DAA's forecasts and figures would be to abdicate this duty. Accordingly, it is beholden on the Commission to evaluate the investment plan and the justification therefore as given to it by the DAA. To the extent that some projects appear not to represent efficient development that meet the requirement and interests of users this is reflected in the calculation of the RAB. That the RAB may be defined as a monetary amount set at level lower than desired by the DAA is not an expression of a predisposition by the Commission to penalise the DAA, but rather is one of a number of possible natural outcomes of the evaluation process that is the essence of regulation.

The Commission has carefully considered the DAA's CIP2006. In February 2007, the Commission published a high-level initial assessment of CIP2006 by its consultant IMR Solutions in order, *inter alia*, to facilitate user responses to CIP2006. The Commission also commissioned from CEPA, and published in February 2007, a cost-benefit assessment of key projects of CIP2006. More recently, the Commission asked consultants RRV to benchmark the proposed levels of capital expenditure and to assess T2 including with respect to how much of its costs might be related to meeting specific airlines' requirements.

In this manner the Commission has had regard to this factor.

(c) ***the level of operational income of Dublin Airport Authority from Dublin Airport, and the level of income of Dublin Airport Authority from any arrangements entered into by it for the purposes of the restructuring under the State Airports Act 2004****.*

The Commission determines airport charges based on the principles of the single till. The Commission remains of the view that, in its application of the single till principle, it should only consider activities that have a sufficient nexus to the operating activities of Dublin Airport. In this manner, the Commission has due regard to the commercial revenue potential of Dublin Airport and fully incorporated this future revenue stream into the Determination, in a manner designed to protect the interests of users of Dublin Airport.

The Commission does not yet have to have due regard to any income arising from the restructuring, since this has not yet occurred.

The treatment of operating expenditure remains the same as in the 2005 Determination.

(d) ***Costs or liabilities for which Dublin Airport Authority is responsible****.*

The Commission carefully considered the costs and liabilities that the DAA is responsible for in its 2005 Determination. This Interim Review has focussed on the costs associated with the capital expenditure programme and policy towards the adding of capital expenditures to the RAB in the future.

(e) ***the level and quality of services offered at Dublin Airport by Dublin Airport Authority and the reasonable interests of the current and prospective users of these services****.*

In considering the CIP2006, the Commission has been mindful of the need for additional capacity at Dublin Airport. Alleviating the crowding at the airport will improve the level and quality of service that prospective users receive.

The Commission has accepted that T2 built to an IATA level of service C will in all likelihood meet the needs of users. However, based on current user input, the Commission does not believe that T1 will necessarily need additional expenditure to improve its service offering. Prospective T1 users have indicated that they would prefer a lower airport charge rather than improved facilities.

In addition the Commission believes that the airport charges users pay should relate to the quality of service provided at the airport. This does not provide a rationale for changing the prevailing price cap, since the projected investments will only benefit users once the projects are complete. The Commission has also sought to protect users having to pay different amounts to realise the benefits from T2, depending on the year in which they use the facility, given that all users will benefit form the reduced congestion and consequent improved quality of service.

(f) ***Policy statements, published by or on behalf of the Government or Minister of the Government and notified to the Commission by the Minister, in relation to the economic and social development of the State.***

No notifications under this particular factor (other than the separate Ministerial Direction) were received by CAR for the purposes of the Review.

On the 2 August 2005 the Minister for Transport notified to the Commission the Department of Transport's Statement of Strategy, 2005–2007, drawing attention, in particular, to the air transport objectives set out in chapter ten of that document. It is noted that this section incorporates all the aviation objectives, not just those relating to airports accordingly, the Commission has addressed the range of objectives set out in that section. The Commission responded to the notification in the Determination and believes that following this Review the Determination continues to take into account those policy statements for the reasons given.

(g) the cost competitiveness of airport services at Dublin Airport.

The 2005 Determination had due regard to the cost competitiveness of airport services at Dublin Airport. This topic has not been revisited during this Review.

(h) ***imposing minimum restrictions on Dublin Airport Authority consistent with the functions of the Commission.***

The current determination is in the form of a revenue cap based on a per passenger yield. This affords a large measure of discretion to the DAA, whilst still allowing the Commission to ensure that it satisfies all its legal obligations.

(i) ***such national and international obligations as are relevant to the functions of the Commission and Dublin Airport Authority.***

The Commission's view on such obligations remains as stated in Commission Paper CP3/2005.

ANNEXES

Annex 1: RRV "Response to Issues raised in Public Consultation Process (RR&V Reports 1, 2 & 3)", 16 July 2007.

Annex 2: RRV "Review of DAA Terminal Sizing Phase II Report and Responses", 11 July 2007.

Annex 3: IMR Solutions "Analysis of DAA criticism regarding methodology", July 2007.