THE AVIATION APPEAL PANEL

DECISION

Members

Patrick Hunt S.C. (Chairperson)

Helen Nolan

George Yarrow

4th April, 2006

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AVIATION APPEAL PANEL

Appeal from the Commission for Aviation Regulation's Determination on the Maximum Level of Airport Charges at Dublin Airport of the 29th of September 2005 (CP3/2005)[1]

DECISION

1. Introduction

1.1 The Commission for Aviation Regulation ("the Commission") was established on the 27th February 2001 under Section 5 of the Aviation Regulation Act, 2001 ("the 2001 Act"). The principal function of the Commission is to regulate airport charges and aviation terminal services charges (Section 7, 2001 Act). Pursuant to Section 32 of the 2001 Act, the Commission was required to make a determination specifying the maximum levels of airport charges that could be levied at Dublin, Cork and Shannon Airports. This determination ("the first determination") was published on the 26th day of August 2001[2] and was subject to a number of appeals as well as Judicial Review proceedings under section 38 of the 2001 Act. An Appeal Panel was established under section 40 of the 2001 Act to consider the determination and the decision of the Appeal Panel, which referred certain matters back to the Commission for review, is set out in its report of the 10th January 2002. The Commission's decision following this referral under Section 40(8) of the 2001 Act was subsequently published on the 9th February 2002[3].

[1] CP3/2005 and other Commission publications are available on the Commission's website; www.aviationreg.ie. Please note that page references are to the online version.
[2] CP7/2001.
[3] CP2/2002.

1.2 The State Airports Act, 2004 ("the 2004 Act") gave legislative effect to the dissolution of Aer Rianta c.p.t., now re-named Dublin Airport Authority Plc. ("DAA") and to provide the legislative basis for the establishment of Dublin, Cork and Shannon Airports as independent Airport Authorities. Part III of the Act also made a number of amendments to the 2001 Act, in particular to Sections 32 and 33 thereof. Section 22(1)(a) of the 2004 Act, amending section 32 of the 2001 Act, required the Commission, as soon as practicable but not later than 12 months after the Dublin appointed day, to specify the maximum levels of airport charges that may be levied by Dublin Airport Authority in respect of Dublin Airport. The Dublin appointed day was designated as the 1st October 2004[4] and in accordance with the statutory timeframe the Commission made its determination ("the second determination") on the 29th of September, 2005.

1.3 Following the publication of this determination the Minister for Transport, Mr. Martin Cullen T.D., received two communications indicating appeals from persons aggrieved by the determination and accordingly on the 9th of February 2006 established this Appeal Panel ("the Panel") pursuant to Section 40 of the 2001 Act, as amended[5].

2. The Scheme of the 2001 Act (as amended)

2.1 The 2004 Act has made a number of changes to the regulatory scheme of the 2001 Act, most significantly by (i) restricting the scope of the Act and (ii) by substituting a new section 33 into the Act.

2.2 The Scope of the Act: -

2.2.1 Prior to its amendment, Section 32(2) required the Commission to make determinations specifying the maximum levels of airport charges that may be levied by an airport authority in respect of all three State

[4] S.I. 531 of 2004; State Airports Act, 2004 (Dublin Appointed Day) Order 2004.
[5] The previous Appeal Panel stands dissolved from the date of notification of its decision to each of the appellants involved in that appeal; section 40(7) of the 2001 Act.

Airports. Section 32(2) as substituted by the 2004 Act now provides as follows:

"The Commission shall-

(a) as soon as is practicable, but not later than 12 months after the Dublin appointed day, make a determination, and

(b) upon the expiration of that determination and each subsequent determination, make a determination,

specifying the maximum levels of airport charges that may be levied by Dublin Airport Authority in respect of Dublin Airport"

The amendment effected by Section 22(1)(a) of the 2004 Act is to restrict the Commission's role to making determinations specifying the maximum levels of airport charges that may be levied by Dublin Airport Authority in respect of Dublin Airport. Cork and Shannon Airports no longer fall within the regulatory remit of the Commission in respect of airport charges and the determination the subject of the appeal relates to the maximum airport charges that can be levied at Dublin Airport only.

2.2.2 Section 22(1)(b) of the 2004 Act also substituted a new sub-section (5). Section 32(5) of the 2001 Act now provides that a determination shall be in force for a period of not less than 4 years, previously 5. It also provides that a determination comes into operation on such day as the Commission specifies whereas previously a determination came into operation not later than 30 days after its making. The Commission may also, on its own initiative or at the request of an airport authority or user concerned in respect of the determination, review a determination and, if it sees fit, amend the determination. Prior to the amendments in 2004, such a review could only take place *"on or after*

the expiration of a period of 2 years after the making of a determination" but these qualifying words have been deleted by the 2004 Act[6]. However, the Commission may still only engage in such a review if it is satisfied that there are *"substantial grounds for so doing"*.

2.2.3 As outlined above, the Commission was under a statutory obligation to make a determination under the revised Section 32 not later than 12 months after the Dublin appointed day, which was the 1st October 2004. Section 22(2) of the 2004 Act provides that any determination made by the Commission under section 32 of the 2001 Act in respect of Aer Rianta c.p.t. that is in force immediately before the Dublin appointed day shall continue in force until the commencement of a determination replacing it is made by the Commission under section 32, as amended.

2.2.4 The definition of the term *"airport charges"* remains unchanged and has the meaning assigned to it by Section 2 of the Air Navigation and Transport (Amendment) Act, 1998. That Act defines "airport charges" as follows:

> *"(a) charges levied in respect of the landing, parking or taking off of aircraft at an aerodrome including charges for air-bridge usage but excluding charges in respect of air navigation and aeronautical communications services levied under section 43 of the Act of 1993,*
>
> *(b) charges levied in respect of the arrival at or departure from an airport by air passengers, or*
>
> *(c) charges levied in respect of the transportation by air of cargo, to or from an airport"*

[6] The words have been deleted from section 32(14)(a) by section 22(1)(c) of the 2004 Act.

2.3 The New Section 33: -

2.3.1 Section 22(4) of the 2004 Act substitutes a new section 33 into the 2001 Act. Section 33 sets out the regulatory objectives of the Commission in making a determination ("the statutory objectives") as well as certain factors which the Commission shall have regard to when making a determination ("the statutory factors"). Both the new statutory objectives and statutory factors reflect the removal of Cork and Shannon airports from the remit of the Commission in relation to airport charges by referring to Dublin Airport and to Dublin Airport Authority as appropriate. For the Commission's conclusions on the impact of the amendments made to the 2001 Act, which were reached after consultation with interested parties, see CP9/2004[7].

2.3.2 Prior to its amendment, the statutory objective was set out in section 33 by way of a single sentence, namely that in making a determination *"the Commission shall aim to facilitate the development and operation of cost-effective airports which meet the requirements of users"*. Subsection (1) now sets out three separate statutory objectives as follows:

"In making a determination the objectives of the Commission are as follows –

(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, and

[7] See also CP7/2004 and CP6/2004 regarding the process of consultation.

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

2.3.3 For the purposes of Section 33, the 2004 Act has defined "user" as meaning any person:

"(a) for whom any services or facilities the subject of airport charges are provided at Dublin Airport,

(b) using any of the services for the carriage by air of passengers or cargo provided at Dublin Airport, or

(c) otherwise providing goods or services at Dublin Airport[8]*"*

2.3.4 Section 33 previously set out ten factors from (a) to (j), which the Commission shall have due regard to when making a determination. Section 33(2) now sets out 9 factors from (a) to (i). Some of the factors are similar to the those set out in Section 33 prior to its amendment: some are entirely new provisions. Section 33(2) now provides as follows:

"*In making a determination the objectives of the Commission are as follows –*

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

(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,

[8] Section 33(5) as inserted by section 22(4) of the 2004 Act.

(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,*

(d) *costs or liabilities for which Dublin Airport Authority is responsible,*

(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,*

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

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

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

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

2.3.5 It should be noted that the factor set out at (a) above, regarding restructuring, is expressly excluded from application to the first determination made after the Dublin appointed day by section 33(3). This is by reference to Section 5(2) of the 2004 Act, which provides that the Cork and Shannon appointed days shall not be earlier than 30 April 2005. Subsection(4) then goes on to provide:

"That the Commission shall, not later than 6 months or such lesser period, after consultation with the Commission, as the Minister decides-

(a) after the making of the first determination, where it is made after the Cork or Shannon appointed day (within the meaning of the State Airports Act 2004), and

(b) where the first determination is made before either of those appointed days, after that appointed day,

have due regard to the restructuring, including the modified functions of Dublin Airport Authority. Where it considers it appropriate it may amend the determination."

2.3.6 "Restructuring" is defined by Part II, section 4, of the 2004 Act as "*the doing of all things necessary for the purposes of giving effect to this Part, and, in particular to sections 7 and 8, in providing for full legal autonomy and independence of each of Dublin Airport Authority, Cork Airport Authority and Shannon Airport Authority*".

2.4 Any challenge to the validity of a determination can only be made by way of an application for leave to apply for judicial review under Order 84 of the Rules of the Superior Courts 1986 (Section 38 of the 2001 Act). Section 38(4) then provides that:

"Notwithstanding an application for leave to apply for judicial review under the Order as against a determination under this Part, the application shall not affect the validity of the determination and its operation unless, upon an application to the High Court, that Court suspends the determination until the application is determined or withdrawn."

2.5 Section 39 of the 2001 Act deals with enforcement and allows the Commission to apply to the High Court for an Order requiring any person to comply with a determination or a request made by the Commission.

3. The Role of the Panel/Appeals

3.1 Section 40 of the 2001 Act sets out an appeal procedure that applies to any of the following persons/bodies aggrieved by a determination of the Commission:

> *"(a) an airport authority to whom a determination under section 32(2) applies,*
>
> *(b) the Irish Aviation Authority in respect of the determination under section 35(2), and*
>
> *(c) an airport user, being any person responsible for the carriage of passengers, mail or freight by air to or from an airport in respect of a determination under Section 32(2) or 35(2)*

3.2 A request must be made to the Minister in writing and must be made promptly but not later than 3 months after publication of notice of the determination to which it relates (Section 40(2A)[9]). The Minister may also refuse to establish an appeal panel to consider an appeal if satisfied that the request is vexatious, frivolous or without substance (Section 40(2B)).

3.3 Section 40(5) sets out the duty of the Panel and provides as follows:

> *"An Appeal Panel shall consider the determination and, not later than 2 months from the date of its establishment, may confirm the determination or, if it considers that in relation to the provisions of section 33 or 36, there are*

[9] Inserted by section 24(c) of the 2004 Act.

sufficient grounds for doing so, refer the decision in relation to the determination back to the Commission for review".

3.4 Where a Panel refers the decision in relation to the determination back to the Commission for review section 40(8) provides that the following shall occur:

"The Commission, where it has received a referral under subsection (5) from an appeal panel, shall, within one month of receipt of the referral, either affirm or vary its original determination and notify the person who made the request under subsection (2) of the reasons for its decision."

4. The Appellant

4.1 The Minister received communications purporting to be appeals from the following persons who were aggrieved by the Commission's determination:

(a) Dublin Airport Authority

(b) Failte Ireland

4.2 Each was served on the Minister and furnished to the Panel and is contained in the Appendices to this decision.

4.3 Failte Ireland is not a body, as defined by section 40 of the 2001 Act, which is entitled to submit an appeal and appropriately expressed its submission in terms of an "observation" on the determination by an interested party. The Panel contacted Failte Ireland who confirmed that it would not require an oral hearing but merely wished its observation to be considered by the Panel.

4.4 For the purposes of this report therefore, references to an appeal shall be a reference to the appeal submitted by Dublin Airport Authority, or "DAA", unless otherwise stated. Insofar as there are comments concerning the previous determination of 26th August, 2001 which affected DAA's predecessor in title Aer Rianta prior to 1st October, 2004, references to DAA

can be taken as including Aer Rianta. Each of the above parties is hereinafter described individually by name or as the Appellant.

5. The Procedures followed by the Panel

5.1 Section 40(4) of the 2001 Act provides that an Appeal Panel shall determine its own procedure. The Panel decided to conduct its proceedings otherwise than in public. The Appellant was invited to make oral submissions to the Panel. Taking account of the Panel's relatively limited role and functions under the legislation, as no other valid appeal was received, and as the matters raised by the DAA concerned the reasoning and general approach adopted by the Commission only in so as they might affect the ability of the DAA to operate and develop Dublin Airport in a sustainable and financially viable manner, the Panel considered it unnecessary to circulate any other persons for comment or to allow other persons to intervene.

5.2 DAA wished to make oral submissions to the Panel and an oral hearing was held on the 9th March 2006. A stenographer kept a record of the entire proceedings and DAA was provided with a copy of the transcript of same.

5.3 In order to assist the Panel in understanding and contextualising some of the issues and submissions raised by DAA, the Panel sought the regulated accounts of DAA prior to the oral hearing. This documentation was provided to the Panel by DAA on the condition that it be treated as confidential and commercially sensitive. For this reason, it does not appear in the appendix.

6. Consideration of the Appeal and the Determination

6.1 General/Introduction

On the 29th September 2005 the Commission for Aviation Regulation issued a determination on the maximum levels of airport charges at Dublin Airport. As indicated previously, the Commission was under a strict statutory timeframe to

produce a determination no later than 12 months from the 1st October 2004[10]. One of the key drivers of this determination *"is the implementation by DAA of the Government's Aviation Action Plan of May 2005 and the delivery of cost effective capacity at Dublin Airport in a timely manner"*[11]. It is this issue and more particularly DAA's ability *"to operate and develop Dublin Airport in a sustainable and financially viable manner"*[12] that has become central to Appeal filed and to the review to be carried out by the Panel.

In this regard the Panel notes that due to a delay in the delivery, by DAA, of a finalised capital expenditure (CAPEX) programme to the Commission[13] the Commission did not have time to analyse the revised DAA CAPEX programme. This analysis was accepted as being "central" to determining the appropriate level of airport charges and it was expressly noted by the Commission that *"it may be appropriate to review the Determination once it and other interested parties (including the Government's own aviation experts) have had time to fully consider the finalised capex programme proposed by the DAA"*. [14]

It was also noted by the Commission that the *"Government has not yet initiated its independent verification of the second terminal proposal"*[15] and further that the Commission would be obliged to have due regard to restructuring upon *"Cork or Shannon Airport Authority becoming vested with the management, development and operation of their respective airports"*. The Commission concluded by saying that *"accordingly, this Determination may be subject to review in the short to medium term"*[16].

[10] 1st October 2004 being the Dublin appointed day. See paragraph 1.2 above.
[11] Per foreword to the Determination of the 29th September 2005; page 3.
[12] Per section 33(1)(c) of the 2001 Act, as amended.
[13] *"A brief high level summary of the finalised capex programme was first delivered to the Commission on the 19th September 2005 – the fifty-first week of a process to which the Commission was allocated 52 weeks";* Per page 3 of the foreword to the Determination of the 29th September 2005.
[14] Per page 4 of the foreword to the Determination of the 29th September 2005.
[15] It now has – see paragraph 6.3.13 below.
[16] Per page 4 of the foreword to the Determination of the 29th September 2005.

6.2 Grounds of Appeal

The Appeal submitted by DAA contains 5 separate grounds of appeal arising from the Commission's determination. These 5 issues or areas of contention raised by DAA can be categorised as follows:

(i) Reductions in allowed CAPEX
(ii) Adjustments to the Regulatory Asset Base ("RAB")
(iii) Pensions
(iv) Commercial Revenues
(v) Cost of Capital/Financeability

DAA estimate that the impact of the Commission's determination has reduced the allowed capital expenditure requested by DAA by approximately 45%, or in excess of €300 million in the first four to five years of its Framework Development Plan[17].

6.3 Reductions in Allowed CAPEX: -

6.3.1 In this context DAA's appeal focuses on the reduction in allowed capital investment for what it says are two key government mandated

[17] Page 7, Transcript of oral hearing. The financial impact for DAA on each element over four years in December 2004 prices is set out in a table at page 3 of the written submissions received by the Panel, content reproduced below:

Element	**Significance for DAA**
Commercial Revenues	A reduction of c28 cent per passenger on DAA's revenue requirement
[redacted]	[redacted]
Reduction in Allowed CAPEX	A reduction of €92.6m in allowed CAPEX
Adjustments to RAB	A reduction of €13.4m on the opening asset base
[redacted]	[redacted]

"The combined impact of the shortfall in each of the areas above is to directly reduce cashflows by c€120m over the four year period and to further reduce prudent borrowing capacity of the Group by a further c€180m; a total deficit in investment capability of c€300m."; per page 4 of written submission of appeal.

projects; namely the delivery of Pier D by 2007 and the delivery of a second Terminal at Dublin Airport and its associated pier by 2009.

6.3.2 In relation to Pier D, DAA estimate a cost of just under €60 million, whereas the Commission's determination provides for a cost of €45 million, representing a reduction of 24%[18]. DAA argue that this reduction was made by the Commission, incorrectly, on the following basis:

(i) that the cost plan provided by DAA is 10% too high when compared with relevant benchmarks, and

(ii) that the size of Pier D should be 15% smaller than what DAA and its advisers are proposing.

DAA are critical of the Commission's use of benchmarks, which are not identified, over a detailed cost plan based on a quantity surveyor's analysis[19]. DAA argue that the lack of transparency in relation to the benchmarks used by the Commission means that possible country specific differences, such as building tender price inflation in Ireland, cannot be addressed[20]. DAA also point to an inconsistency between the consultants retained by the Commission on this issue[21].

In relation to the proposed reduction in size for Pier D, DAA argue that planning permission has already been obtained for a 29 metre width Pier; that the design allows flexibility by facilitating both narrow and wide-bodied stands and that the assertion that pier widths in the range of 22 – 24 metres is more usual is not borne out by an examination of pier widths at comparable European Airports[22]. DAA also argue that the size of 29 metres was accepted by airlines after a consultation

[18] Page 22 written submission of Appeal.
[19] Franklin & Andrews and Keogh McConnell; per page 24 written submission of Appeal.
[20] Page 23 written submission of Appeal.
[21] RR & V and WHA/IMR. Page 17, transcript of oral hearing.
[22] Page 18, transcript of oral hearing; page 24 and 25 written submission of appeal.

process with DAA and the main users and airline associations at Dublin Airport[23].

6.3.3 The Panel considers that the reduction in allowed CAPEX in relation to Pier D calculated by the Commission in its decision was unreasoned, arbitrary and illogical.

It would appear that it may be more expensive at this advanced stage in the construction process to downsize. Even if the pier size were to be reduced now by virtue of the Commission's decision, it would be reasonable to expect that the Commission would have included provision in the determination for the cost of delays associated with redesign, planning permission and consultations which a decision to reduce pier width now would necessarily entail.

6.3.4 The Panel is of the view that the details of design and configuration, including pier width, are not essentially a matter for the Commission as regulator to adjudicate upon. These details are a matter principally for DAA, subject to consultation and discussion with its owners and customers. There can be a role for the regulator in the event of major disagreement, such as might in this case have arisen, for example, if airlines and/or other users had expressed a clear preference for a smaller facility, or in the event that the budgeted costs of certain aspects of design and configuration appeared manifestly excessive or profligate. The Commission's reasoning is not, however, based upon a prior conclusion that one or other of these conditions has been satisfied.

6.3.5 The Panel considers that the Commission should have properly considered allowing a cost for the Pier D proposal on the basis of a 29m Pier width, in accordance with the planning permission already given and following the consultation process during which, so far as

[23] Pages 139-144, transcript of oral hearing.

we are aware from the determination, there was no strong view in favour of the lower width suggested by the Commission's consultant. If, however, such a strong view in favour of a smaller facility did exist, the Commission should properly have taken it into account in its reasoning.

6.3.6 In relation to the costings applied to a facility of given size, the Panel is of the view that the benchmarking exercise relied upon by the Commission is insufficiently robust to warrant a substantial adjustment to the DAA CAPEX plans.

6.3.7 The Panel has a concern, heightened by the abstract and theoretical nature of a discussion in the determination about the implications of "asymmetric information", that the Commission believes that DAA will always significantly over-estimate its investment costs, and that the appropriate regulatory response is to adjust those estimates downwards by a significant amount, no matter how limited the available evidence on the magnitude of the perceived bias in estimation.

6.3.8 Apart from the arbitrary nature of the cost adjustments made, there may be some confusion as to the implications of economic theory as it relates to the relevant issues. It is notable that there appears to be a procedure of making relatively arbitrary, downward adjustments to costs, with the implied intention of correcting for assessment bias. This necessarily implies a disincentive for good faith conduct by DAA and is out of line with best practice incentive regulation. If the Authority provides its best available information on projected costs, it can expect to earn less than a normal rate of return on investment, by virtue of the expected, downward adjustments that will be made. A more appropriate regulatory response to the information problem would be to seek more vigorously to verify the information provided, discuss and consult on alternatives and only substitute the

Commission's own reasoned alternative when there is very clear evidence of assessment bias.

For these reasons, the Panel recommends that this decision is reviewed.

6.3.9 In relation to Terminal 2, DAA submitted a requirement of 47,000 square metres whereas the Commission has reduced that figure by some 40% to 29,000 square metres (an adjustment that appears to have been heavily influenced by benchmarking on Terminal 1). DAA argue that Terminal 1 is not an appropriate benchmark for Terminal 2 in light of current congestion.

6.3.10 DAA's figure of 4,700 square metres per million passengers per annum appears to the Panel to be relatively conservative in the light of comparisons with international benchmarks, including the SERAS (South East and East of England Air Services Study) standard of 6,600 square metres per million passengers adopted in the context of the development of a recent UK White Paper[24].

6.3.11 We note that DAA's current advice from international architects and experts involved in the design of Terminal 2 is that it will need to be in excess of 50,000 square metres in size to deal with expected passenger numbers[25].

6.3.12 The Panel notes that the Commission's approach to CAPEX allowances for Terminal 2 was necessarily of a provisional nature, given the significant uncertainties about likely costs that remained at the time of the determination. We are therefore of the view that it was reasonable for the Commission to err on the side of caution in the inclusion of future expenditures in the determination, at least until better information became available. However, for reasons similar to

[24] UK Department of Transport: The Future of Air Transport December, 2003; per page 26 written submission of Appeal.
[25] Pages 19-21, transcript of oral hearing.

those discussed in relation to Pier D, we think there is considerable risk in formally linking such caution to particulars such as the size of the terminal and low benchmarks for costs per square metre. For example, one risk is that capital markets will, on the basis of the Commission's reasoning, interpret regulatory policy as biased against the adequate remuneration of capital.

6.3.13 The adoption of a provisional approach to Terminal 2 CAPEX implies that the Commission should review the matter again, at such time as some of the major uncertainties have been resolved. In this context the Panel notes that on 22nd March, 2006 the Minister for Transport appointed an independent expert group to advise him on the costs to be incurred on the construction of Terminal 2 with a deadline to report to him in June, 2006. It is to be expected that, at the conclusion of this process, significantly more information will be available about the expected scope and costs of the Terminal 2 project. The Panel considers, therefore, that the Commission should commit to review its determination on Terminal 2 issues immediately following the report of the independent expert group.

6.3.14 In the interim, in relation to Terminal 2, the Panel considers that the Commission decision to reduce the notional, allowed size of the terminal is arbitrary and illogical and we would recommend that the Commission review same.

The Panel considers (for the reasons set out above) that sufficient grounds have been established to refer the Commission's decision in relation to the matters addressed in this section.

6.4 Adjustments to RAB: -

6.4.1 DAA argue that in relation to two matters that the Commission has made arbitrary and inappropriate retrospective adjustments to the RAB by:

(i) Stranding, permanently, a portion of the cost invested in Pier C during the last regulatory period for alleged "*imprudent investment"*; and

(ii) Stranding the estimated income earned by DAA in relation to Pier D, over the previous regulatory period, on the allowed spend for Pier D which did not take place[26].

The second issue raised by DAA is perhaps more appropriately described as a "clawback" and is referred to as such below. DAA argue that each of the above adjustments by the Commission raises significant concerns regarding the remuneration of any future investment and acts as a disincentive for investment and increases regulatory risk.

6.4.2 In relation to the stranding of €13.4[27] million, or 22% of the cost associated with Pier C in 2001, DAA argue that the stranding is based on an erroneous assertion that the construction costs were higher than that of similar buildings in Dublin. DAA argue that this assertion is incorrect because the benchmarks used; a warehouse, an office and a hospital are not "similar buildings". DAA argue that when benchmarked against similar piers at other airports, the cost of both phases of Pier C would be on the lower end of the scale. DAA further argue that the stranding approach adopted by the Commission is unbalanced and inequitable when Pier C was approved by the then Regulator (the Minister for Transport) and was built, within budget to the lowest tender received[28]. It was built in two phases, both of which were separately and distinctly approved and completed within budget.

[26] Page 22, transcript of oral hearing
[27] Per page 30 written submission of Appeal.
[28] Page 23, 145, transcript of oral hearing.

6.4.3 In relation to the clawback of €6.6 million in estimated income associated with Pier D[29] during the last regulatory period, DAA argue that this is an arbitrary adjustment of just one element of the price cap. DAA argue that if retrospective adjustments of this type are being made the Commission should have retrospectively adjusted for other discrepancies over the last regulatory period. DAA highlight that the Commission over-estimated, by €90 million, the commercial revenues DAA (then Aer Rianta) would earn during that period and point out that this was revenue the Commission accepted it was necessary for the company to earn. DAA point out that some €7.5 million was expended during the same period on design costs associated with the Pier. DAA further argue that the delay in building Pier D was due to factors outside the control of the company and notes that the Commission accepts this fact[30].

6.4.4 In relation to CAPEX, the allowances are set following an assessment of the company's capital investment programme (CIP) and its likely costs. On the basis of the 'standard' approach to CPI – X regulation, which the Commission indicates that it is seeking to follow, the projected expenditures allowed in calculating regulated charges are not linked to particular projects or project outcomes. The rationale for this is that, in general, things will not usually go exactly to plan. Indeed flexibility to adjust plans, as new information becomes available, is to be positively encouraged. Flexibility may mean some projects not going ahead at all, others being delayed or brought forward, and yet others being introduced into the investment programme for the first time.

6.4.5 It is also a key principle of the standard CPI – X approach that price or charge caps, once determined, are 'pre-determined' for the relevant period, meaning that, although the charges may be adjusted (e.g. to reflect inflation), they will be adjusted in ways that cannot be

[29] Page 76 of the Determination of the 29th of September, 2005.
[30] Page 24, 153, transcript of oral hearing.

materially influenced by either the regulator or the regulated undertaking. 'Clawback' violates this principle, since it is equivalent in economic effect to retrospective, discretionary adjustment of charges that were intended, and promised, to be pre-determined. Given this, the Panel considers that 'clawback' should only be contemplated in circumstances in which there has been prior and manifest non-compliance by the company.

6.4.6 Given that the regulatory settlement between Commission and company is a relatively broad one, with performance requirements not spelled out in detail, the Panel believes that the notion of "compliance" must be given a similarly broad meeting. It does not simply mean deviating from plan (it is very rare that the assessed CIP will actually be fully implemented), nor does it simply mean operating inefficiently (most companies in most markets operate in ways that fall short of maximum efficiency).

6.4.7 The Panel considers that clawback could properly be considered legitimate if:

- DAA/Aer Rianta had deliberately misled the Commission. There is an obvious rationale for seeking to prevent a company from gaining benefit from such conduct. In the context of CAPEX, this might occur if DAA/Aer Rianta had included a project in its CIP that it knew at the time (but the Commission did not know at the time) would not be feasible in the relevant period.

- DAA/Aer Rianta's performance can be characterised as being akin to negligence: conduct falling short of what might reasonably be expected. That is, the bar is set at a minimum acceptable standard of performance, not the economists' ideal of efficiency, which is a "best possible" standard. Again, in such circumstances the case

for compensation (in the form of clawback) is obvious, on basic principles.

The defining feature of the circumstances in which clawback might be justified is some manifest deficiency in the conduct of the DAA, such that its performance falls to an unacceptably low level.

6.4.8 In making these observations, the Panel does not seek to imply that the Commission necessarily has to follow the standard CPI – X approach. In the context of CAPEX an alternative option might be to introduce a more contractualised system in which revenue allowances are related to defined events or outcomes. This is an approach that has attracted interest in other jurisdictions. If, however, this type of option were to be favoured, the appropriate way forward would be via detailed consultation and the development of a transparent set of principles and rules that would be readily understandable by capital markets. Retrospective adjustments such as clawback almost invariably give rise to regulatory uncertainty.

6.4.9 We note that the difficulties associated with alternative approaches to CAPEX are implicit in the Commission's determination. At Annex 15, concerned with the option of introducing rolling schemes (which would be a more incremental reform to current arrangements than would contractualisation), para 5 states:

"The Commission also favours the introduction of a rolling scheme in respect of commercial revenues as well as for capital expenditure. In the latter case, where the design of such a mechanism would be complex, careful analysis and industry consultation would need to precede the introduction of a rolling efficiency scheme." (emphasis added)

The Panel believes that this comment on the relative complexity of CAPEX issues is correct, but would suggest that the desirability of

careful analysis and of consultation extends across all significant changes to regulatory policy.

6.4.10 In relation to 'clawback', the Panel also notes that the Commission appears to have applied this approach very selectively, to Pier D allowed CAPEX only. Whilst it is understandable that users might feel aggrieved that an allowance was made for investment activity that did not materialise within the relevant period, it is also the case that the earlier charge determination was based on projections of DAA commercial revenues that also did not materialise. These (inaccurate) projections were to the benefit of users. Again we have a concern that the Commission may, via retrospection that is focused only on investment activity, signal a rather negative regulatory attitude to CAPEX to the investment community.

6.4.11 The Commission decision to maintain the stranding of Pier C costs raises equally fundamental issues. Disallowances for imprudent investment were a feature of rate-of-return regulation as practised particularly in the USA. This was because of concerns that rate-of – return led to incentives for inefficiently high investment. On the other hand, economic analysis based on CPI – X regulation tends to emphasise the potential danger of under-investment.

6.4.12 In relatively new regulatory systems, where the relevant regulatory body has not had sufficient time to establish a firm reputation for respecting property rights, disallowances of capital expenditure from the RAB can potentially create material, adverse regulatory risk and uncertainty. The RAB reflects the future claims of investors on the income of the regulated company. Reductions in the RAB by the Commission amount to reductions in those claims, and unless such actions are guided by credible and legitimate principles they will be perceived as a form of capital expropriation.

6.4.13 The Panel considers that the circumstances under which RAB disallowances might legitimately be justified are similar to those discussed in relation to clawback. That is, they are only justified in the event of some manifest deficiency in the performance of the regulated company, such as would be considered to be outside normal commercial parameters. In the specific context of Pier C, the Panel can see no evidence of such conduct on the part of DAA. While we recognise that, with the benefit of hindsight, the Commission might have concluded that the costs of Pier C could potentially have been lower than the approved budget, that is not, in our view, anywhere close to providing sufficient grounds for disallowing what appears to be an arbitrarily determined fraction of the relevant expenditure. Given the uncertainties surrounding capital projects, there is scope for a variety of views about what is the most efficient way forward, each of which might be considered reasonable. Only if DAA can be shown to have strayed outside the bounds of reasonable conduct or made an unreasonable decision about the type of capital expenditure incurred should there be any 'disallowance' issue for the Commission to consider.

6.4.14 The Panel finds it very difficult to understand how costs, legitimately incurred on Pier C, on budget and with the approval of the Minister (there then being no outside Regulator) can now apparently be permanently stranded. If this is because Aer Rianta did not formally appeal this aspect of the previous determination to the last Appeal Panel, this Panel does not believe that DAA are 'estopped' from contesting the decision to (apparently) permanently strand this expenditure now.

The Panel considers (for the reasons set out above) that sufficient grounds have been established to refer the Commission's decision in relation to the matters addressed in this section.

6.5 Pensions: -

6.5.1 On the issue of pensions, DAA argue that while the Commission has accepted the important principle that efficient pension costs should be allowed within the regulatory determination, it has erred in failing to use the most up to date figures available to it. DAA argue that the Commission should have relied on the actuarial figures as at the end of April 2005, provided at the end of June 2005, [redacted] DAA argue that this failure on the part of the Commission is significant, as it reduces DAA's ability to fund CAPEX and increases the uncertainty and regulatory risk associated with the business.

6.5.2 The Commission in its determination concluded that, having regard to the intention to decouple the Aer Lingus/DAA joint scheme in the near future and the uncertainty surrounding the magnitude of the deficit, it would allow only some of the costs that DAA has estimated are required to fund the deficit.

6.5.3 The Panel feels that the Commission's approach in this regard is reasonable in view of the uncertainties surrounding the current pension scheme. The Commission's determination clearly signals that it fully recognises the principle that DAA pension costs should be recovered, and that the approach taken this time around is, by design, a partial one. Although the DAA is correct in saying that the Commission decided not to adjust the allowance in the light of the most up-to-date actuarial calculations, the partial allowance by the Commission can be seen as reflecting a broad judgment. As such, it is not necessarily linked in any very mechanistic way to a particular set of actuarial numbers. In our view, therefore, while it was open to the regulator to increase the partial/provisional allowance upward on receipt of the

[31] Page 74, transcript of oral hearing; page 20 written submission of Appeal.

latest information, there was nothing unreasonable in the decision not to do so.

The Panel does, however, note the Commission's commitment to review these matters[32] and would be strongly in favour of such a review at the appropriate stage.

The Panel considers (for the reasons set out above) that sufficient grounds have not been established to refer the Commission's decision in relation to the matters addressed in this section.

6.6 Commercial Revenues: -

6.6.1 DAA argue that the Commission has consistently over-estimated the revenue potential in this area, with significant consequences in a single till regulatory system[33]. DAA argue that the Commission's assumptions in regard to commercial revenues are flawed because unsound benchmarks are being used and the Commission is failing to compare "apples with apples". A bottom-up approach is required.

6.6.2 In relation to the issue of benchmarks[34], DAA highlight a number of specific difficulties, as follows:

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[32] "*However, this treatment of the pension deficit is subject to adjustment. The Commission* ***will have to reconsider in due course****: - the actual magnitude of the deficit using different measures and having regard to the intention of the DAA to create a new scheme; - the proportion that it is appropriate to fund through airport charges levied at Dublin Airport; (emphasis added)* Per page 69 of the Determination of 29th September, 2005.

[33] *"DAA considers that the review carried out by the Commission's consultants ASA does not provide a sound basis for forecasting commercial revenues in the 2006-2009 period as it assumes that DAA will earn c€25m [the majority of which relates to car, parking, property and retail revenues] in excess of that which DAA's own forecast indicate is achievable…. the Commission made similar unfounded assumptions in its 2001 Determination which assumed that DAA would earn €90million more from commercial revenues in the period 2001-2004 that it did and set its charges to reflect that assumed revenue. No subsequent adjustment for this error was included in the 2005 Determination";* per page 5 written submission of Appeal

[34] *"ASA's aggressive growth assumptions… appear to stem from the conclusion that in 2002 Aer Rianta's Commercial Revenue per passenger at Dublin Airport was only 48.6% of the average of the Leading European Airports/Airport Groups (Source: TRL/ATRS), i.e. a very simple, crude benchmark and a wholly unreasonable basis for business planning."*; per page 6 written submission of Appeal.

"…it is interesting to note that ASA's views regarding the alleged "gap" in DAA's performance when compared with other airports is diametrically opposed to the views of another of the Commissions'

(i) The British Airport Authority defines retail business as including foreign exchange and other sorts of concession type revenue that is not taken into account in DAA's retail revenue, which focuses on retail shopping specifically. DAA argue that an appropriately adjusted comparison, with this revenue taken into account, shows Dublin Airport jumping from 13th position[35] to 5th position and operating within the top quartile of comparator airports[36].

(ii) There has been a failure to have due regard to the significant differences in passenger mix at Dublin Airport and some of the comparator airports, with equally significant effects on revenue achievable. DAA argue that Dublin Airport has a passenger mix of approximately 85% short haul, low cost carrier passengers with just 15% transcontinental duty free passengers. When compared with an airport like London Heathrow, which has equal numbers of those types of passengers, the revenue per passenger achievable at Heathrow will be significantly greater[37]. DAA argue that Dublin Airport is trying to serve both the duty-free market, which is small in proportion but high in value, and the duty paid market and that, while the Commission has recognised that fact in making commercial revenue forecasts, because the above markets have been co-mingled, the Commission has failed to recognise properly the consequence of this in terms of the forecasts made[38].

(iii) That due regard has not been given to the operation of factors such as the euro on UK comparator airports (in relation to foreign

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consultants Booz Allen Hamilton (BAH). BAH recently evaluated data on traffic and economic benchmarks for 25 European Airports and notes that Dublin: '…has the highest proportion of retail and concession business of all the airports in our study"; per pages 6 and 7, written submission of Appeal.

[35] URS Retail Report

[36] Page 32, 33 of transcript of oral hearing. Page 16 written submission of Appeal.

[37] Page 39 of transcript of oral hearing. See also, page 16 of written submission of appeal.

[38] Page 40, transcript of oral hearing.

exchange) and the accession of ten additional European countries in May 2004[39].

(iv) That DAA's own commercial forecasts assume a progressive liberalisation of the Shannon stop-over and an open skies policy from January 2008. DAA point out that the consultants[40] retained by the Commission to review this forecast felt that DAA's assumptions were excessively benign in this regard but that this was not accepted by the Commission, demonstrating an asymmetric approach to risk[41].

6.6.3 DAA argue that the Commission's assumptions regarding increases in revenue from property and rents are erroneously linked to a growth in passenger numbers. While DAA concede that some concessionaire agreements operate on a turnover basis with minimum guarantees[42], it argues that the majority of its property income can only be increased by either (i) adding to the property portfolio or (ii) increasing the rent or prices paid.

(i) DAA argue that the growth in revenues projected by the Commission due to increased passenger numbers cannot be met from existing property stock. DAA argue that the Commission has erred in extrapolating a growth in revenue from forecasted increases in passenger numbers without making any allowance for the provision of the additional property stock that would be required to meet that forecast[43]. This is especially relevant to assumed growth in the area of car-parking, particularly long-term car-parking, which is already at capacity during peak periods and subject to strict planning conditions[44]. In the area of retail, DAA argue that assumptions that retail space on the mezzanine floor

[39] Page 40, 41 transcript of oral hearing.
[40] Walsh & McDonald.
[41] Page 55, 72, transcript of oral hearing.
[42] Page 42, transcript of oral hearing.
[43] Page 43, transcript of oral hearing.

would generate the same revenue per square metre as if it were on the main thoroughfare is not borne out by international practice[45].

(ii) DAA argue that the Commission's assumptions for growth in rents linked to passenger numbers are particularly flawed when viewed in a context where [redacted] of DAA's total stock of rental properties has rent review clauses which have rents fixed until [redacted]. In relation to car-parking revenues, DAA argue that penetration levels, particularly in the area of short-term car-parking, are decreasing relative to passenger numbers due to a fall-off in the numbers of "meeters and greeters" attending the airport[47]. In relation to long-term car-parking, DAA argue that the prices factored in by DAA are already strong and that competition in this area limits the prices achievable.

6.6.4 While DAA make many detailed points about the Commission's forecast of commercial revenues, the Panel considers that there is a common argument of principle running throughout, which is that the Commission has consistently ignored or set aside relevant evidence in favour of a simpler, selective and ad hoc approach to assessment. The Panel notes the Commission's conclusion in relation to commercial revenues is very much based on extrapolations and benchmarking exercises performed for it by Alan Stratford and Associates. We further note that, notwithstanding the significant over-projection of commercial revenues by the Commission at the time of the previous charge determination, there is no discussion in the current

[44] Page 46, 50, transcript of oral hearing.; pages 8 - 12 written submission of Appeal.
[45] Page 71, transcript of oral hearing.
[46] [redacted]

determination of the possible reasons for that particular outcome. In our view, this omission is unlikely to inspire confidence that the Commission's commercial revenue projections on this occasion will be significantly more accurate than in the past.

6.6.5 The Panel considers that the Commission has estimated the growth in revenues from property and, in particular, car parking charges in a somewhat simplistic and mechanistic manner without regard to specific factors such as the timing of rent reviews (a legal matter) and limiting factors in relation to the potential for growing the car parking income stream.

6.6.6 The Commission, the Panel feels, has overemphasised the link between commercial revenues and passenger growth. We do not doubt that there is likely to be a link between revenues and passenger growth, but, by focusing so heavily on this particular factor, the effect is that the projections are based upon an approach that systematically ignores other relevant factors and evidence.

6.6.7 The Panel has considered whether the approach taken by the Commission might be justified on grounds of proportionality: that is, can it be expected that that the extra costs of developing more sophisticated projections would be materially higher than any potential benefits? Our conclusion is that the simple approach cannot be so justified, for reasons that include:

- Commercial revenues are an important factor in airport regulation by virtue of the single till approach to regulation. A reduction in commercial revenue of €1 million will have a similar effect on allowed airport charges as a €1 million increase in projected OPEX.

[47] Page 45, transcript of oral hearing.

- The significance of commercial revenues at Dublin Airport is relatively high by international standards, accounting for around 70% of total revenue. A one percentage point 'error' in the forecast of commercial revenues will, therefore, have a somewhat greater percentage effect on allowed, maximum airport charges, and will have a significant effect on DAA's profitability.

- Much of the information relevant for forecasting commercial revenues will be gathered and processed by DAA as part of its normal commercial activities. The Commission is not, therefore, necessarily faced with a major information gathering exercise of its own.

Given these points, the Panel is of the view that a more analytical and bottom-up approach to commercial revenues, based upon an assessment of a wider body of relevant information and evidence, should have been taken by the Commission.

The Panel considers (for the reasons set out above) that sufficient grounds have been established to refer the Commission's decision in relation to the matters addressed in this section.

6.7 Cost of Capital/Financeability: -

Cost of Capital

6.7.1 In regard to the issue of the cost of capital, DAA argue that the WACC[48] estimate adopted by the Commission was flawed as it was based on an inaccurate estimation of the beta component for Dublin

[48] Weighted Average Cost of Capital – this is computed as the weighted average of DAA's cost of equity and its cost of debt, with the weights given by shares of equity and debt in DAA's total financing; see page 17 of the Commission's Determination of the 29th September 2005.

Airport, with a consequential inconsistency between the beta component in terms of gearing and the costs of debt assumptions[49].

6.7.2 On the issue of financeability, DAA's appeal focuses on the Commission's alleged failure to address the statutory objective of enabling DAA to operate and develop Dublin Airport in a sustainable and financially viable manner[50]. In the Draft Determination the Commission commented that:

"A key question, and perhaps the defining question for this consultation, is whether the new statutory objective of financial viability in Section 22 of the 2004 Act requires an upward adjustment in the Commission's calculation of the airport charges cap in order to enable Dublin Airport's sustainability and financeability?"[51]

6.7.3 DAA argue that the Commission erred in failing to make any upward adjustment to charges to address this issue and specifically reject the Commission's view that DAA can remain sustainable and financially viable below a single "A" credit rating *"as any rating below this level would have adverse implications for the cost, availability and terms of financing available to DAA, potentially limiting or delaying ability to invest in infrastructure. Commencing such a major capital expenditure programme with a BBB rating* [which the Commission has accepted as adequate] *where the ability to curtail or terminate expenditure once the plan is embarked upon is limited, exposes the company to the possibility of a major adverse shock at a time when it would be financially vulnerable"*[52].

6.7.4 DAA recognises that it would be possible to raise finance at levels below its current "A" rating[53] but stresses that there is a difference

[49] Page 98, transcript of oral hearing and pages 40 and 41, written submission of appeal.
[50] Page 100 transcript of oral hearing. Page 34, written submission of Appeal.
[51] Per page 38, Draft Determination of the 31st May 2005.
[52] Per page 35, written submission of Appeal.
[53] Per Page 36, written submission of Appeal.

between the availability of finance and "financeability". DAA argue that it is runs contrary to the statutory objective of enabling *"Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner"* for the Commission to, in effect, "invite a credit downgrade to BBB"[54].

6.7.5 

6.7.6 DAA argue that the Commission has taken an asymmetric approach to risk that, in overall terms, is unreasonable[57].

6.7.7 In evaluating the merits of DAA's appeal on these issues the Panel sets out its analysis as follows:

6.7.8 Cost of Capital

It is generally acknowledged that cost of capital estimation is not a mechanistic exercise, but requires the exercise of judgment on a whole set of detailed issues. A generous judgment on one component of the calculations may be counterbalanced by less generous judgments on others. Except in cases of egregious error in one part of the exercise, the Panel believes that it is the overall assessment that matters. To

[54] Per page 38, written submission of Appeal and page 106, transcript of oral hearing.
[55] Pages 104, 116, 125 and 126 transcript of oral hearing.
[56] Page 125 and 126, transcript of oral hearing.
[57] Page 109, transcript of oral hearing.

proceed otherwise would be to endorse a 'cherry picking' approach of the type that we have rejected in relation to CAPEX issues.

For the purpose of the Appeal, DAA focuses on two variables:

- The company's *asset and equity betas* which are measures of its non-diversifiable or systematic risk, and

- The DAA's *gearing*.

The difference in view between DAA and the Commission is summarised in the following table, which shows the estimates of the relevant factors made by Kearney and Hutson (KH), upon whose study the Commission relies, and by NERA, upon whose study DAA relies.

	KH	NERA
Asset beta	0.61	0.7
Equity beta	1.1	1.4
Real cost of equity	***9.2%***	***11.4%***
Gearing	***46%***	***50%***

It is evident from this table that the major issue at stake is a difference in view as to the real cost of equity. The DAA's specific reference to issues surrounding the estimation of betas arises because it is differences in these beta estimates that are largely responsible for the different estimates of the costs of equity capital in the two studies (KH and NERA).

6.7.9 Gearing

The Panel notes that:

- the difference in assumed gearing is a relatively modest one, and

- the weighted average cost of capital (WACC) generally tends to *fall* as gearing is increased, at least within a typical range, so that substitution of a 50% figure (NERA) for the 46% figure in the KH calculations could, other things equal, be expected to *reduce* the NERA WACC estimate.

  In the Panel's view, there is no reason to think that the Commission's assumption concerning the gearing ratio leads, or could potentially lead, to a significant under-estimate of the relevant cost of capital

6.7.10 The Market Cost of Equity

On the evidence before the Panel, there is little divergence between the Commission and DAA experts' estimates of the market cost of equity. Both estimates can be said to be at the high end of the range of possibilities suggested by the evidence presented, which is largely based on studies of historic returns to equity and on precedents from other regulatory determinations. The relevant estimates refer to equity returns from investing in diversified portfolios of stocks and should in principle, be similar across particular determinations. Relevant benchmarks are not, therefore, limited to airport cases.

6.7.11 The Beta Estimates

In relation to the estimation of asset and equity betas, relevant evidence is limited by virtue of the fact that DAA is not a quoted company. However, the KH estimate of the asset beta lies well within the range of possibilities indicated by recent statistical evidence from those overseas airports whose shares are traded on equity markets. Although it is arguable that a higher estimate might be justified, it is equally

arguable that a lower estimate could be justified, particularly taking into account DAA's status as a regulated monopoly.

KH's estimate of DAA's equity beta follows directly from their estimate of the asset beta and their assumption concerning the benchmark level of gearing, upon which we have commented above. Hence, it raises no further issues, and the Panel considers that it does not need to form a view on the technical issue of 'de-gearing the equity beta' raised by NERA, which, as the Commission pointed out, does not in any case radically affect the overall cost of capital assessment.

6.7.12 The Overall Balance

DAA's appeal is based on the proposition that the allowed pre-tax return of 7.4% (6.46% post tax) is insufficient in the context of the need to finance a sustained period of significant capital expenditure in the regulatory period, and it is supported by detailed points concerning the KH estimate of DAA's asset beta, which accounts for the bulk of the divergence between the NERA and KH estimates of the cost of capital.

In the Panel's view, the Commission's determination is not ungenerous, particularly when compared with broadly comparable regulatory precedents in relation to the post-tax cost of capital. The only proviso is that, if the concerns we have raised in other parts of this Decision are not addressed, capital markets might come to require higher debt premia to compensate for perceived asymmetries in regulatory risk. However, the Panel considers that the better way to approach this issue is to address the fundamentals, which relate to regulatory certainty and regulatory risk, rather than to make ad hoc adjustments to the cost of capital estimate.

The Panel considers (for the reasons set out above) that sufficient grounds have not been established in respect of the matters addressed in this section to refer back to the Commission.

6.8 Financeability

DAA's arguments are grouped under four headings:

1. The availability of finance and financial viability are not the same issue.
2. The risk profile of the company has changed.
3. (The Commission's) Assumption of credit rating downgrade.
4. Underestimation of a downgrade in DAA's credit rating on the cost of capital.

6.8.1 As a general matter, the Panel believe the significance of financial ratios and credit ratings in any particular determination must be seen in the context of the determination as a whole. If business prospects are sound, then notwithstanding the fact that capital markets do not necessarily function perfectly, it is a reasonable presumption that those capital markets will, one way or another, provide the appropriate levels of finance on terms that allow the (sound) prospects to be realised.

6.8.2 This view is implicit in S&P's statement to the Commission in relation to credit ratings, which the Commission implicitly accepts, "*that in setting a credit rating for a firm, it does not merely apply financial metrics in a mechanical fashion but also considers the background business, economic and policy environment*."[58]

6.8.3 The Commission goes on to accept S&P's assessment that "*it views the underlying business environment of Dublin Airport as very strong: being an essential facility for a major population centre in a strong economy with a government shareholder.*"[59]

[58] Per page 37 Determination of the 29th of September, 2005
[59] Per page 37 Determination of the 29th of September, 2005

6.8.4 On the question of whether, if appropriate allowances have been made in the risk assessment of the underlying business, for new major projects, there is any need for further 'financeability' adjustments in price determinations, the Panel inclines toward a negative response. It is difficult to see why such adjustments should be necessary in general, and rather specific reasons would probably be required to justify them. The DAA's arguments, however, are of a general nature, and not focused on any particular specific difference between the Dublin situation and airport regulation overseas.

6.8.5 The Panel believes that once the underlying business risk has been assessed, the credit rating of a company's debt depends, among other things, upon its gearing. Higher gearing tends to depress the credit rating of debt, but this does not necessarily mean that the overall cost of capital will be increased. There is a tax advantage to debt, and the cost of equity may also be reduced to the extent that, at high levels of gearing, debt capital may be absorbing some of the business's underlying systematic risk. These are obviously trade-offs for consideration when assessing the overall cost of capital and its optimisation.

6.8.6 The Commission has explicitly taken the view that maintenance of an A grade rating is not necessary to ensure that the sustainability and financial stability obligation (SFV) is met, and has made the judgment that "*the SFV objective is reasonably achieved if the company's financial projections are robustly consistent with investment grade ratings …*"[60]

6.8.7 In the view of the Panel this conclusion is fully reasoned, supported by evidence and consistent with regulatory determinations made relatively

[60] Per page 36 Determination of the 29th of September, 2005

recently in the UK in sectors (water, energy networks) that also face major CAPEX programmes.

6.8.8 DAA argues that "*… the results anticipated by the Commission in its determination reflect a significant deterioration in the financial standing of DAA from that prevailing during the period of the previous determination.*"[61] It seems to us that this statement conflates the "*financial standing of DAA*" with the financial standing of one particular set of financial instruments (debt).

6.8.9 The Commission during the process offered to consider the possibility of accelerated depreciation allowances in order to improve shorter-term financial ratios. Accelerated depreciation would have increased DAA cash flows over the next pricing period, at the expense of cash flows in later periods (via reductions in the RAB). DAA rejected this approach – which potentially offered higher cash flows in the shorter term, while being neutral in terms of net present value on a longer term basis – and, in doing so, effectively signalled that its SFV concerns were less to do with short-term financial ratios and credit ratings than with the balance of the determination as a whole.

6.8.10 The DAA's argument to the effect that the Commission has underestimated the effects of a downgrade in DAA's credit rating on the cost of capital, therefore appears to be the crucial issue that is raised by this ground of appeal.

6.8.11 The Panel has reached the following conclusions on this aspect of the appeal:

- The existing downgrading from A to A- is, according to S&P, linked to the uncertainties surrounding the current price review, which are likely to include uncertainties arising from the

[61] Per page 38 written submission of appeal

introduction of the new legislation. Once these uncertainties have been resolved, and particularly if the overall cost of capital determination is considered to be satisfactory, the credit rating impacts may be mitigated.

- Even if a significant downgrading occurs, and there is a subsequent increase in the cost of debt, this does not necessarily mean that there will be a significant increase in the overall cost of capital. The downgrading may, for example, simply reflect the anticipated increase in gearing.

- Given that DAA rejected the possible option of accelerated depreciation, its argument seems to the Panel to amount to the self-contradictory proposition that "*DAA's allowed cost of capital should be increased, so as to obtain a lower cost of debt, so as to be able to achieve a lower cost of capital*."

6.8.12 In summary, since there appears to the Panel to be no sustainable argument established to the effect that DAA will simply not be able to raise the finance required for its CAPEX programme, it seems to the Panel that the financeability arguments can be reduced to a proposition that the Commission determination has set too low a cost of capital, and our conclusions on that matter have been set out at 6.7.12 above.

6.8.13 The Panel is therefore of the view that DAA's arguments in this regard do not indicate that DAA will be unable "*to operate and develop Dublin Airport in a sustainable and financially viable manner",* within the meaning of section 33(1)(c).

The Panel considers (for the reasons set out above) that sufficient grounds have not been established to refer the Commission's decision in relation to matters addressed in the section.

7. Conclusion

Pursuant to Section 40(5) of the Act, the Panel hereby refers the decision in relation to the determination of the 29th September, 2005 back to the Commission for review.

Dated this 4th day of April, 2006.