Note Accompanying Varied 2019 Determination

Following 2020 Aviation Appeal Panel Decisions

Commission Paper 4/2020

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1. Introduction

1.1 On 24 October 2019 the Commission published its fifth Determination of the Maximum Levels of Airport Charges at Dublin Airport (CP8/2019), 'the 2019 Determination'.[1] The 2019 Determination covers the five-year period from 1 January 2020 to 31 December 2024 and is expressed as an annual per passenger price cap.

1.2 On 4 February 2020 the Minister for Transport, Tourism and Sport established an Appeals Panel under Section 40(2) of the Aviation Regulation Act 2001 (as amended) to consider the appeals of two parties, Dublin Airport and Ryanair, against the 2019 Determination. The Appeals Panel issued its decisions on these appeals on 4 May 2020. The Appeals Panel referred two points to the Commission for further review, namely the mathematical application of the Operating Cost (Opex) passthrough mechanism and the length of the glidepath (achievability adjustment) allowed by the Commission in relation to operating costs (Opex).[2]

1.3 On 2 June 2020, the Commission published a consultation document on proposed variations to the 2019 Determination in response to the two referrals.[3] We received submissions from Dublin Airport and Ryanair which are published alongside this document.

1.4 We have reviewed the submissions received and have decided to vary the 2019 Determination as we proposed in June. Specifically, we have made some adjustments to the price cap formulae such that the Opex passthrough mechanism will function as was intended, and we have removed the Opex glidepath adjustments in 2022 and 2023.

1.5 The Appeals Panel, in consultation with the participants in the appeal, concluded that it would be appropriate for the purposes of the appeal to have regard only to material which was available to the Commission in October 2019, and not subsequent events. The Commission has taken the same approach. Therefore, the subsequent onset of the COVID-19 pandemic is not relevant for the purposes of the appeals process. The Commission has separately issued a consultation document (CP3/2020) on potential interim reviews of the 2019 Determination due to the impact of the pandemic.[4]

1.6 This paper, which is published alongside the varied 2019 Determination (CP5/2020), sets out our responses on the consultation submissions received.

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[1] https://www.aviationreg.ie/_fileupload/2019%20Determination/Final%20Determination/2020-2024%20Determination.pdf

[2] https://www.aviationreg.ie/_fileupload/2019%20Determination/Appeals%20Panel%202020/Aviation%20Appeals%20Panel%20daa%20appeal%20decision%204_5_20.pdf
https://www.aviationreg.ie/_fileupload/2019%20Determination/Appeals%20Panel%202020/Aviation%20Appeals%20Panel%20Ryanair%20appeal%20decision%204_5_20.pdf

[3] https://www.aviationreg.ie/_fileupload/2019%20Determination/Appeals%20Panel%202020/2020-06-02%20Appeal%20Panel%20CAR%20Consultation%20paper.pdf

[4] https://www.aviationreg.ie/_fileupload/2019%20Determination/COVID%2019/COVIDConsultation.pdf

2. Opex Passthrough Mechanism

2.1 Following the referral of the mathematical application of the Opex passthrough mechanism on foot of the daa appeal, the Commission proposed to:

- Make no change to the components of the w Factor, which would continue to allow for the remuneration of the best estimate of the quantum of qualifying costs, with a one-year lag.

- Undo the change to the k Factor pertaining to the passthrough mechanism. The k Factor would therefore be unrelated to the passthrough mechanism, but would revert to dealing with general under-collection as has been the case in previous determinations.

- Introduce a new term called the y Factor. This term would adjust for forecasting error in passenger numbers or qualifying costs, to the extent that such error has caused imperfect remuneration through the w Factor. This term would operate with a two-year lag.

Responses Received

2.2 Dublin Airport supports the proposed introduction of the y Factor. Dublin Airport states that it would have been useful for the purpose of understanding the proposed change in the formulae if the Commission had defined further the different elements of the new y term and the existing w term, as well as the 'LMOpex' element. It further seeks assurance that if necessary, any qualifying costs which are unremunerated during this determination period could be brought forward into the next regulatory determination period.

2.3 Dublin Airport noted that the input '$LMOpex_{CARApprovedOutturn}$' for a given year t may be different in the W term in year t+1 relative to the Y term in year t+2. This is to allow for forecasting error in the input included in W, which will need to be calculated before the end of year t.

2.4 Dublin Airport is unclear as to the rationale for the adjustment to the K Factor formula.

2.5 Ryanair made no comment on this proposed variation.

Decision

2.6 We have made the changes to the price cap formulae as proposed.

2.7 The components of w and y are as stated in the 2019 Final Determination. The formula adjustments, including the y factor, rearrange the price cap formulae such that the mechanism will work as was intended, rather than changing any aspects of the components. The mechanism is intended to deal with uncertainty; consequently, there is an uncertainty component, '$LMOpex_{CARApprovedOutturn}$'. This component is necessarily set out in terms of the principles of its application, rather than how it would apply to specific situations which are, as yet, uncertain. These principles are set out in paragraphs 6.47 to 6.50 of the 2019 Determination. We will engage with Dublin Airport as specific relevant line items, and the quantum/scope of each, become clearer. All other components are defined.

2.8 We confirm that '$LMOpex_{CARApprovedOutturn}$' for a given year t may be different in the w factor in year t+1 relative to the Y term in year t+2 to correct for forecasting error either in passenger numbers or the quantum of qualifying costs in year t. As we noted during the appeals process, the question of adjustments accrued in this period which would be due for remuneration in the next period cannot be predetermined as part of the 2019 Determination. However, we also confirmed that any such outstanding adjustments from 2023 or 2024 would need to be appropriately allowed for in the next determination if the Commission is to be consistent in its approach. There is no reason why, all else equal, qualifying costs accrued over 2020-2022 would be remunerated but those over 2023-2024 would not be. This is the same as what has occurred in previous periods. For example, in the 2019 Determination we adjusted for outstanding under-collection and variation in CAR costs from the previous period.

2.9 In subsequent engagement, we clarified the issue of the adjustment to the k Factor formula with Dublin Airport, which relates to consistency with the approach set out in text in the Final Determination, rather than any substantive change from the Final Determination.

3. Opex Glidepath Extension

3.1 In the 2019 Draft Determination, we provided for a two-year glidepath before adopting the more efficient figure identified by our consultants, CEPA. In the Final Determination, we extended this to four years. The Appeals Panel was not convinced that the extended glidepath was necessary and asked us to reconsider the length of the glidepath beyond the two years.

3.2 Following the referral of the Opex glidepath extension by the Appeals Panel on foot of the Ryanair appeal, we specifically assessed the achievability of the CEPA figures from 2022, having regard to Dublin Airport's 2019 position on the basis of the assessment carried out by Frontier on behalf of Dublin Airport and data provided by Dublin Airport in July 2019. That is, we assessed in a granular way whether a two-year glidepath should have been considered achievable.

3.3 We concluded, as was suggested by the Appeals Panel and in line with Ryanair's position on this point, that the CEPA figure should have been considered reasonably achievable from 2022 and consequently a two-year glidepath was sufficient. We therefore proposed to remove the glidepath adjustments for 2022 and 2023, in order to maintain the balance between challenge and achievability.

3.4 We set out the conclusions of our analysis in relation to the FTE assumptions, which can be summarised as follows:

- Overall, the CEPA assumption would allow for around 100 more FTEs by 2022.

- Increases in certain categories, in particular Retail and Security, are partly offset by reductions predominantly in non-frontline areas, particularly Central Functions.

- Natural attrition of staff over 2019-2022 would have enabled Dublin Airport to staff at or very close to the assumed levels in 2022, in the categories where reductions were identified as achievable from an operational perspective by CEPA. This is not the case for 2020 or 2021.

- Having regard to the specific areas where CEPA identified that there was scope for improvement, the nature of that improvement set out by CEPA, and the material provided by Dublin Airport, we have not identified any persuasive evidence indicating that it should not be considered achievable from an operational perspective by 2022.

- There are a number of categories where arriving at the CEPA FTE assumption for 2022, given the actual 2019 position, poses a challenge. On the other hand, there are other categories which CEPA concluded are largely efficiently staffed, or where certain efficiencies are more quickly achievable. In the round, therefore, we consider that overall CEPA's assumptions are achievable from 2022 following the two-year glidepath.

3.5 We noted that the CEPA assumptions on unit payroll costs for 2022 would have allowed for real growth (i.e. before inflation is added) of between 1.5% to 3% by 2022.

3.6 In relation to Non-Payroll costs, we noted that the CEPA 2022 figure would again allow for real cost escalation relative to 2019. The scope for efficiencies identified here largely relates to different views of the future, rather than baseline adjustments. Consequently, we did not consider that Non-Payroll costs warranted the extended glidepath.

Responses Received

3.7 Dublin Airport states that it is 'extremely aggrieved' that the Commission is now proposing to remove the Opex glidepath for 2022 and 2023 'without new evidence to justify such a substantial change in its approach'.

3.8 Dublin Airport provides commentary around general aspects of the Opex allowances, namely:

- how the allowed Opex increases in the 2019 Determination compare to the level of increases sought by Dublin Airport, which is then further compared to the level of increases sought by Dublin Airport in previous periods.

- that 170 staff have been disallowed which mainly relate to frontline areas such as Security, Facilities & Cleaning, Retail and Airside Operations (130) and non-frontline/back office staff (40). It states that to achieve this target a significant restructuring of the airport business would be necessary but despite this the Commission made no allowance for the associated restructuring costs which would be required to implement this level of change.

- CEPA did not provide substantiation for its analysis.

- Dublin Airport's Opex per passenger in 2018 was 'competitive' relative to other airports.

3.9 Dublin Airport states that a glidepath is a recognised regulatory tool used to encourage the regulated entity to achieve cost savings, and that regulatory precedent clearly demonstrates how glidepaths stimulate the regulated entity to make incremental efficiency improvements beyond those that would be achieved under a regulatory regime in the absence of a glidepath. It concludes that the use of the glidepath delivers additional efficiency improvements with benefits for customers and end users.

3.10 Dublin Airport notes that we previously concluded that a sharp reduction in Opex could have had implications for Dublin Airport's ability to meet our targets relating to other building blocks, most notably service quality. It states that achieving cost savings through natural attrition takes a certain length of time which it believes would not be viable in the two-year period now being proposed.

3.11 Dublin Airport is concerned that the Commission has not provided any evidence to assess the impact of the reduction in the price cap for 2022 and 2023 on Dublin Airport's financial ratios in those selected years.

3.12 Dublin Airport references the challenge posed by COVID-19.

3.13 Ryanair supports the proposed variation, stating that the achievability of these targets is entirely reasonable. This is without prejudice to Ryanair's overarching view that the appropriate starting point should have been lower than the 2019 figure used by the Commission. Ryanair considers it important that, ahead of any Interim Review of the 2019 Determination due to the COVID-19 crisis, key principles are established now, specifically in this case the need to establish an efficient level of Opex and to ensure that this is attained in a timely manner.

Decision

3.14 We have reduced the glidepath back to the original two years as proposed in our draft decision. We were not provided with evidence to suggest a longer glidepath should have reasonably been considered necessary on the grounds of achievability.

3.15 We do not accept that new evidence in relation to the proposed variation was not provided, nor that the proposed variation represents a substantial change in our approach. The appeal point upheld did not relate to the overall approach to Opex, but rather whether this approach was correctly and robustly applied in relation to the glidepath in 2022 and 2023. Where an Appeals Panel upholds an aspect of an appeal, the Commission is required to reassess the issue. Our detailed conclusions, based on the analysis by CEPA, Frontier, and Dublin Airport's July 2019 figures, were set out in the consultation. Dublin Airport has all of this underlying material. It has previously identified much of the underlying detail, as well as the Frontier forecasts, as confidential. We therefore did not publish this detail.

3.16 Dublin Airport's general commentary does not address the specific appeal point which was referred by the panel, namely whether containing cost increases from the actual 2019 position to the level set out by CEPA for 2022 should reasonably have been considered achievable. The evidence regarding the broader Opex assessment is set out in the CEPA reports and the draft and final determinations. These points have previously been addressed.

3.17 Dublin Airport does not provide evidence indicating either that any of the conclusions we set out in the consultation document were incorrect, or more broadly why containing cost increases such that the CEPA figure for 2022 would have been attained is not possible or is unreasonable. The claim that a three-year glidepath is required to allow for the CEPA FTE assumptions to be attained through natural attrition is not supported by evidence.

3.18 As we set out in the consultation document, the CEPA assumptions for 2022 would in fact have allowed for more frontline FTEs in security, retail, and cleaning staff relative to Dublin Airport's actual position in 2019. This can be calculated from the referenced material. As we set out in the consultation document, the evidence supports the position that the CEPA 2022 figure should have been considered achievable without any requirement for a Voluntary Severance Scheme (VSS). However, Dublin Airport is incorrect in stating that restructuring costs were not allowed for. The remuneration of Dublin Airport's proposed VSS was set out in paragraphs 6.55 to 6.58 of the Final Determination.

3.19 We agree with Dublin Airport that a glidepath was required relative to the CEPA number for 2020, so that the Opex allowances would be achievable and consistent with the approach we adopted in relation to other building blocks. This was also accepted by the Appeals Panel. The point referred by the panel was whether the duration of the glidepath was appropriate. A glidepath is required in certain circumstances to ensure a balance between achievability and challenge is maintained. Clearly, allowing for a longer glidepath where the evidence suggests a shorter one is sufficient would in fact both weaken efficiency incentives and result in airport users paying higher levels of airport charges than necessary.

3.20 Circumstances arising from the COVID-19 crisis are not considered as part of this appeals process. The Commission has separately published a consultation document on potential Interim Reviews of the 2019 Determination arising from the pandemic.

3.21 Changes in allowed Opex do not impact the modelled financial ratios in the base case, as we assume, for the purpose of modelling ratios, that actual opex will equal our targets. The variation to the 2019 Determination on this point relates to our revised position as to what is achievable by 2022. Furthermore, the downside scenarios modelled by Centrus for its financeability report ahead of the 2019 Final Determination included a scenario where Dublin Airport failed to meet the Opex targets, as they were set out in the Draft Determination.[5]

[5] https://www.aviationreg.ie/_fileupload/2019%20Determination/Final%20Determination/Financeability%20Assessment%20_Final%20Report.pdf

Subsequently these targets increased by a total of €118.9m in the Final Determination in the base case scenario. This variation remains comfortably within the bounds of the downside scenarios, which ultimately drove Centrus recommendations on the financial ratios we should target.