AIRPORTS COUNCIL INTERNATIONAL
EUROPE

8 July 2019

Commissioner Mannion
3rd Floor, Alexandra House
Earlsfort Terrace
Dublin 2, D02 W773
IRELAND

Olivier Jankovec
Director General

Re: Response to the 2019 Draft Determination CP3/2019

Dear Commissioner Mannion,

Airports Council International Europe (ACI EUROPE) represents the interests of over 500 airports in Europe across 46 countries and has extensive experience in playing a constructive role in the formation of aviation policy. ACI EUROPE's mission is "*to advance the development of safe, secure, sustainable and efficient airports for the benefit of the travelling public and businesses, as well as local and regional communities throughout Europe*". In carrying out this mission, our General Assembly has mandated us to specifically focus on the interest of passengers and the development of air connectivity to support the economic development of airport communities while addressing the climate impacts of our sector.

We commend the Commission for Aviation Regulation (CAR) for being one of the most outspoken and determined national authorities to ensure that the purpose of regulation is to serve passengers. The European aviation industry needs to be regulated in a manner which reflects both the local and European business environment and market dynamics it is operating within.

European airports are facing the challenges of intensified competition, while still being required to provide extensive capacity to meet demand for air services in the decades ahead. Airlines systematically seek to lower short-term costs relating to infrastructure. Airports seek to develop their facilities in the long-term and deliver an adequate return for illiquid and immobile investment with high intrinsic risk.

In many cases, and in our view Ireland is no exception, economic regulation is 'caught in the middle' allowing for airport users to treat the process as a gaming opportunity to lower airport charges. Under-regulation undermines economic efficient outcomes, by introducing the risk of abuse of market power. Yet over-regulation is equally threatening, distorting the market and introducing potentially damaging disincentives. The regulator's challenge is to find the correct balance, which ensures effective protection and promotion of consumers' interest for affordable and varied connectivity.

ACI EUROPE is concerned that the draft determination has not found the correct balance.

1. Financing investment & risks of incorrect WACC determination

ACI EUROPE is of the opinion that a more flexible regulation better serves the need to attract financing into the illiquid, immobile and very costly airport sector. The recent era of low interest rates and the possible result of a weighted average cost of capital (WACC) that is too low should be especially concerning to a regulator focused on the long-term interests of passengers.

This is important, because it is widely recognised that the negative costs to social welfare of setting WACC too low are greater than setting WACC too high.[1] There is a continuing need for investment in the airport industry to meet future demand, modernise and improve quality as well as ensure sustainability and environmental protection. The social costs of deferred investments are greater than the potential social costs of higher prices.

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[1] Agenda; Aiming high in setting the WACC: framework or guesswork? (March 2015) https://www.oxera.com/agenda/aiming-high-in-setting-the-wacc-framework-or-guesswork/

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Airports need to remain incentivised to deliver adequate investment in capacity in the years ahead, and this requires aviation authorities at all levels, European and Irish, to tailor economic regulation to the current competitive state of the industry. It is incumbent upon authorities such as the CAR to ensure that its policies support efficient market outcomes, which take full account of the long-term sustainability of the industry.

It is well documented that there is a shortfall of investment in airport infrastructure in Europe, which is leading to capacity shortages and unmet demand. In our view, this requires flexibility by regulators and willingness to take new approaches to ensure that planned capital expenditure takes place. In recent years, we have noted a trend of actual capital expenditure falling below plans, which indicates that there is a mismatch between the needs of airports, and what the financial and regulatory conditions allow.

When reviewing the draft determination, ACI EUROPE is concerned that the WACC allowed for Dublin Airport will be insufficient to assure financial markets of the ability of Dublin Airport to derive revenues that support the level of planned investment. We urge the Commission to ensure that it has properly tested the financeability of the proposals, to protect the needs of future users.

2. Airlines will not pass the reduction in airport charges to passengers

ACI EUROPE has observed that airport users are supportive of stable pricing as airlines require planning stability and benefit from airports that are high-quality and performant.

Airport charges are a relatively small and stable part of total airline costs, incurred for the use of airport facilities and services. As such, airport charges can and do influence airlines' capacity planning and network development, as airlines seek to maximise their own returns by focusing on the most profitable routes.

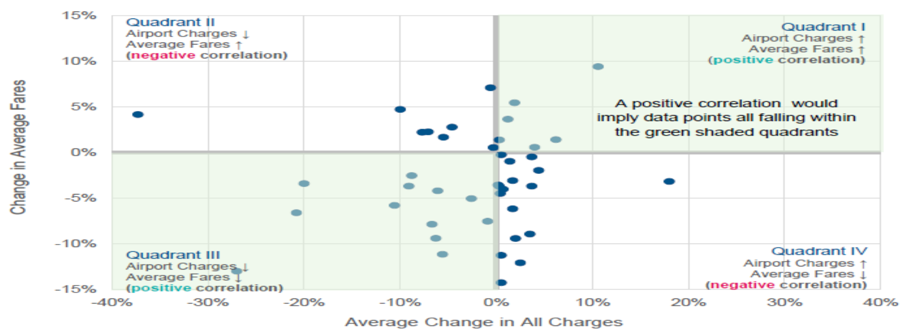
However, there is no one-for-one correspondence between airport charges- and any change in their level - and air fares. Indeed, airport charges usually have a non-significant influence on air fares, which are constantly changing, based on dynamic pricing techniques driven by demand patterns, price elasticity and the level of competition on any given route.

This can be seen well by looking at fuel surcharges. During the last oil spike in 2010, many airlines did pass-through fuel cost increases via dedicated fuel surcharges and/or higher air fares. However, it is also worth remembering that these surcharges still lingered on when fuel prices returned to pre-spike levels. This revealed a notable asymmetry in pricing decisions to the detriment of consumers – and once again illustrates how airlines will always aim to exercise their pricing power irrespective of the underlying costs of providing the service on a given air route.

Evidence for this comes from an analysis by the consultancy ICF of specific case studies in which airports have adjusted their charges, and the impact that has had on airline fares, presented in the figure below.

The lack of clear pattern makes the point: There is very little correlation between changes in air fares and changes in airport charges. Hence, there is no evidence to prove that airlines departing Dublin Airport will reduce air fares.

Figure: Changes in Airport Charges vs. Changes in Average Fares[2]



Note: Scatter Plot shows observations where a change in charges occurred. The airports observed include Amsterdam, Brussels, Gothenburg, Helsinki, Ljubljana, Sofia, Stockholm, Vilnius, Warsaw, Zagreb and Zurich from 2010 to 2017. A given airport can account for multiple data points corresponding to different years.
Source: ACI EUROPE airport charges survey, IATA PaxIS

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[2] Identifying the Drivers of Air Fares, An ICF report prepared for ACI EUROPE, May 3, 2018

Therefore, the sharp reduction in the per passenger price cap at Dublin Airport will not be seen by passengers departing from or arriving at Dublin Airport. Given the capacity constraints present, airlines will be able to collect a larger scarcity rent.

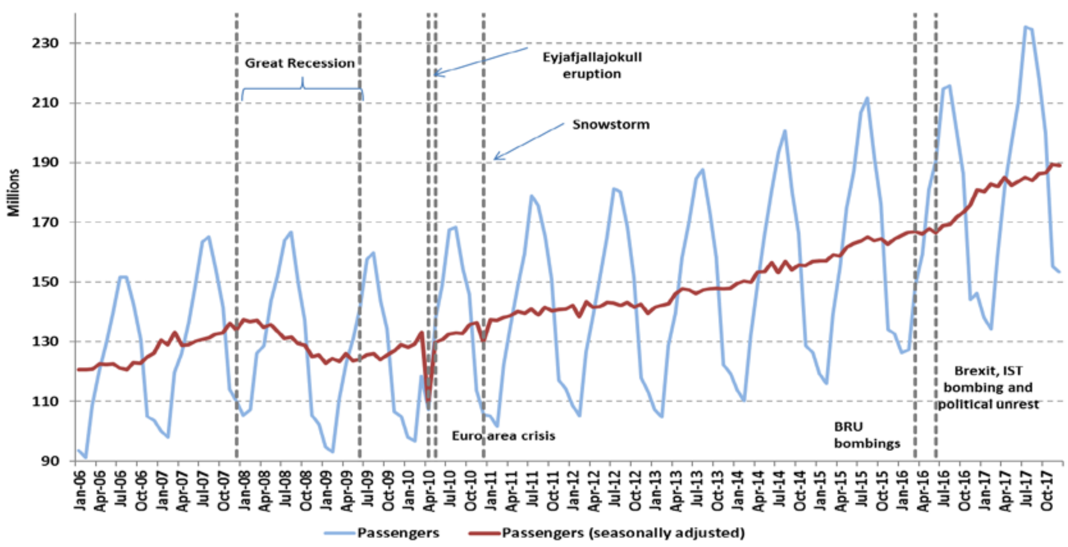
In essence, what CAR has proposed will result in a transfer of earnings from the airport to the airlines operating at the airport. Passengers will not see a benefit, and may even suffer if the resulting loss slows the airport's ability to put in place its capital expenditure plan.

3. Preparing for economic downturns

CAR's draft determination is motivated by recent above-expectations conditions for the development of air traffic in Europe. While CAR wisely moderates the future growth forecasts, it still does not prepare for a shock to the system, whether sector specific or economy wide.

The chart below, showing the evolution of passenger traffic, suggests that our industry, to be resilient, must be prepared for risks. Because the airport sector is exposed to this volatility, unlike other regulated entities who are much more protected, it is another reason for adjusted risk factors in the cost of capital calculation.

Evolution of monthly passenger traffic in Europe (2006–2017)



The Commission should recognise the potential for shocks in its financial forecasts.

4. Operational costs

CAR sought expert advice in building a ground-up estimate of the efficient operational costs for Dublin Airport. The proposals in the draft determination state that Dublin Airport can reassert control over operating costs and can continue to achieve efficiencies.

ACI EUROPE, noting its wide range of experience with airports in Europe, believes that CAR has underestimated the complexities associated with managing the volumes of passengers when an airport reaches the size threshold of Dublin Airport. The 'idée fixe' of constantly decreasing cost curve for a firm over the long run, does not hold for airports. Empirical evidence is clear that airport costs per work load unit (WLU = 1 pax or 100 kg of freight) decrease to the volume of around 20 – 30 million work load units, but that after that volume operating cost per unit increase.

While the chart below is for total costs, we would be happy to provide additional detail for operating costs only.

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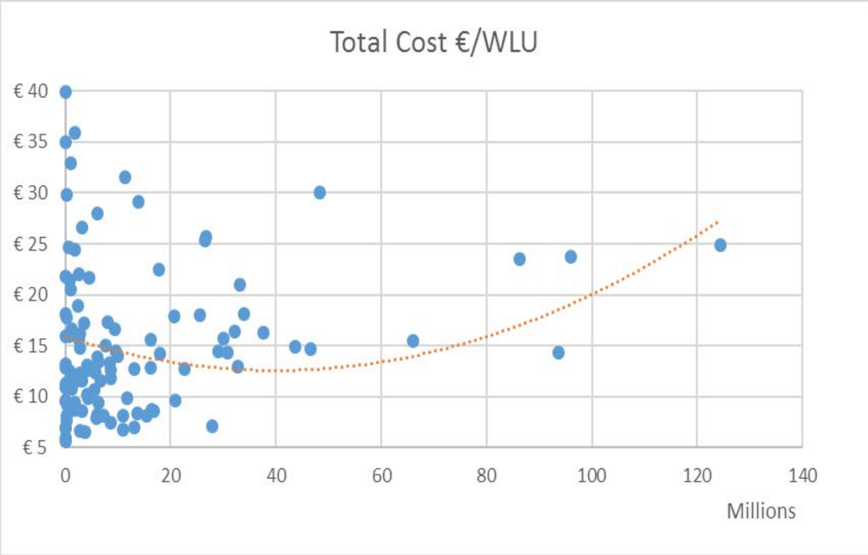
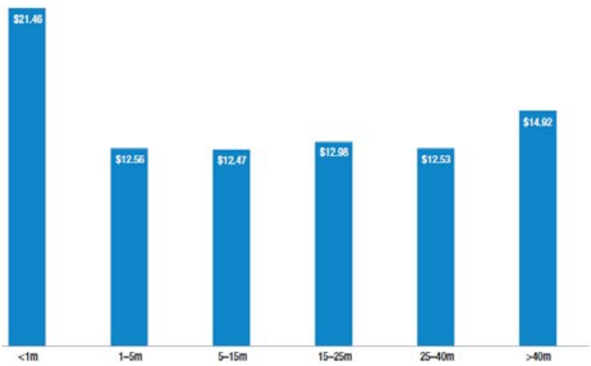
Figure: 2018 airport level data for European airports



Global and long-trend evidence shows that per unit operational expenditure can start to increase at a certain passenger volume, in the range of 15 – 30 million passengers a year. The chart below shows that the convex shape of the cost curve is empirically consistent.

Figure: Total Cost per passenger (Source: ACI WORLD Airport Economics 2019 Report, p 37)

Total cost per passenger (US$) by airport size category (2017)



Source: ACI Airport Economics Survey (2018)

In their work, CEPA has underestimated the costs of growth and overestimated economies of scale. The conclusions on allowed operating costs should be revisited using this lens.

5. Airline buyer power

The draft determination states that the market power of Dublin Airport has increased because of its concentration of market share. Such an assessment misses the ability of users to deny use of that power. Countervailing buyer power (CBP) is a key part of assessments of market power and recognised as a strong commercial tool in European competition practice. When assessing CPB, markets must be defined from the seller's point of view. This nuance is important as it means that an airport supplying into a market where one or two customers have a large share of purchase is facing dominant buyers in a nearly monopsonistic market. Intuitively, it is no surprise. In what other sector could a supplier be reliant on one customer accounting for up to half of its business, and have limited and contracting outside prospects for new customers?

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Rather than present more statistics, we can simply re-state what European airlines say. Airlines are clear and transparent about their buyer power in their audited annual financial reports. Examples from recent financial reports from Europe's top 5 airlines demonstrate that airlines are aware of and exercise their power:

- "*In absolute terms, airport and handling charges increased by 4%, from €830.6 million in fiscal year 2016 to €864.8 million in fiscal year 2017, reflecting the 13% increase in traffic* ***offset by more competitive airport deals****….*" (Ryanair FY 18 annual report)
- "*We are growing where the* ***cost and quality are right****. This is also why we are waiting until next summer to decide,* ***based on the development of the hubs****, where the new Boeing 777-9 aircraft will be taking off from as of 2020.*" (Lufthansa Group press release 27 September 2018)
- "*Air France - KLM has* ***significant leverage*** *via its procurement policy and purchasing volumes which it can use to encourage responsible practices across the supply chain.*" (AF/KLM Registration Document 2016)
- "*As easyJet increases in size, the airline will drive further economies of scale from long-term deals with airports (…)* ***management continues to work with airports*** *that will reward easyJet's commitment and growth with attractive financial packages. For example, despite 80% of outbound airports being regulated,* ***airport and ground handling costs decreased by -1.3%*** *per seat at constant currency*". (easyJet Financial Statements FY17)

The Commission for Aviation Regulation should take note of this increasing power of airlines, especially in an era of consolidation where airlines have a stronger position vis-à-vis passengers. In this market situation, regulators have a new impetus to ensure that they derive a balanced outcome that protects the needs of people travelling at the airport.

6. The long-run for regulation

ACI EUROPE welcomes the opportunity to comment on the draft determination by the Commission. At a time when more than €40 billion in investment is required at European airports over the next 5 years to meet demand expectations, and Dublin Airport itself plans €2 billion in investment, which the Commission has recognised is aligned to the needs of users, it is critical to allow the conditions to finance this investment.

ACI EUROPE urges the Commission to rebalance its draft determination. The financeability of the full investment programme should be assessed, alongside the impacts on air fares. The resilience allowed the airport through preparing for economic shocks has a key place in the framework. Assumptions about operating costs for airports, such as Dublin Airport, which are emerging as key secondary hubs, need to bechallenged and the costs that come with complexity included in the determination.

We remain at your disposal for further information.

Best regards,