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Aer Rianta Response

to Submissions to the

Commission for Aviation Regulation

on

The Economic Regulation of Airport Charges in Ireland (CP2/2001)

17th April 2001

Table of Contents

1 Introduction

Aer Rianta made an initial detailed submission to the Commission for Aviation Regulation on 27th March 2001, in accordance with the process outlined by the Commission in its document CP1/2001. Along with submissions from other interested parties, this document has been available on the Commission's website since April 2nd, and the Commission has invited responses to this material by April 17th. This document is Aer Rianta's response to the submissions of other parties. Appendix 1 contains a number of further detailed comments relating to incorrect or misleading information noted in other submissions which Aer Rianta believes it is necessary to address.

Aer Rianta has laid out this response under a series of headings covering the main points made by other parties in their submissions. As a preface, the Aer Rianta proposal on the economic regulation of airport charges outlined in its submission of 27th March 2001 is summarised as follows:

- Aer Rianta should be regulated as a single entity in order to ensure that maximum benefit from economies of scope are maintained, to minimise the regulatory burden and to ensure that the role of airports as engines of growth at a regional level is maintained.

- Aer Rianta advocates the use of an incentive regulatory price cap of the form RPI+/-X, applied to the average aeronautical yield per passenger. This model will ensure that economic welfare is optimised, and provides for the sharing of ongoing efficiency benefits between the airport authority and users through a profit-sharing mechanism. Aer Rianta proposes to re-structure airport charges to encourage users to utilise its airports in the most economically efficient manner, and to provide optimum signals regarding the timing of infrastructure development.

- The dual till approach is the most appropriate framework for independent regulation of Aer Rianta airports, as it efficiently signals the economic costs of provision of infrastructure both to airport users and airport authority.

- In order to ensure that Aer Rianta is capable of delivering facilities in the future to meet customer requirements, it is appropriate that valuation of assets within the regulatory till should be based on a replacement cost methodology, and that asset values should be rolled forward in a manner to ensure that development can be sustained.

- Aer Rianta's ability to fund ongoing investment in the future is dependent on achieving a reasonable rate of return on assets. The rate of return permitted should be equivalent to the cost of capital, which must be carefully derived in the light of the specific market conditions within which Aer Rianta operates.

- Implementation of the capital investment programme will be a key step in delivering Aer Rianta's strategy for the future. Efficiency in capital investment is in the interests of both airport authority and airport users, and therefore Aer Rianta is very supportive of the concept of comprehensive capital investment analysis. It is necessary to ensure that all airport costs are recovered, from the time that they are incurred, to ensure sustainability of operations.

- Aer Rianta engages in an intensive programme of consultation, in relation to the current and prospective needs of all airport users. The challenge for Aer Rianta is to consider the varying objectives and requirements of the extended airport community, and to balance short–term requirements with proper long-term planning for the ongoing development of the airports.

- Benchmarking can provide useful information for the Commission where appropriate comparisons are made, although there are many difficulties in obtaining accurate comparative data. In particular, comparisons must be made on the basis of similar investment and operating profiles.

- Aer Rianta agrees that it is important for service standards and the associated costs to be debated between customer and provider. Standards should be broad enough to meet the requirements of a range of customer types.

- Overall, Aer Rianta is committed to assisting the Commission in its task of ensuring that the requirements of current and prospective users are met in an economically efficient manner, while retaining for itself the commercial and operational mandate conferred in the Air Navigation and Transport (Amendment) Act 1998 and other legal and regulatory mandates under which the airport must operate.

2 Context for Regulation

In its initial submission, Aer Rianta discussed the overall framework within which it operates, in terms of the statutory framework, and specifically on the Air Navigation and Transport (Amendment) Act 1998, and the policy framework deriving mainly from the Department of Public Enterprise 1998 Statement of Strategy.

It is interesting to note how few of the submissions from other parties focused on this important issue, one which is fundamental to the operation of the airports, and determines to a very large extent the approach Aer Rianta must take in relation to the operation and development of its three airports.

Many of the submissions lodged on the Commission website seem to view Aer Rianta as providing a public service similar to education or health services. In reality, state and semi-state companies exhibit great diversity in terms of their commercial focus. Aer Rianta's approach to the operation and development of its airports is based on a strong commercial ethos. This focus has determined that Aer Rianta was, in many respects, a truly international company before many privately owned companies in Ireland. Aer Rianta has grown and developed successfully, both at home and abroad. The Irish airports are gateways to a strong and dynamic economy, and Aer Rianta is committed to ensuring that they continue to be appropriately developed as an effective catalyst for growth in both business and leisure travel sectors for the future. This, however, cannot be done without proper investment and funding.

The operation of Aer Rianta as a commercial semi-state company has been endorsed at government level. It was made clear by the Minister for Public Enterprise[1], during Oireachtas debates relating to the Aviation Regulation Act 2001, that development of Aer Rianta facilities will not be effected through public funding, and that Aer Rianta, like other semi-state companies, is expected to operate as a stand-alone commercial entity. This approach is also reflected in the statutory objectives set out for the company in the Air Navigation and Transport (Amendment) Act 1998, and in the objectives outlined for the Commission in the Aviation Regulation Act 2001. Aer Rianta has never received State funding for the development of its airports and has always operated with a commercial mandate and funded investments in its airports from profits and borrowings.

2.1 Section 33

The objective of regulation has been defined in Section 33 of the Aviation Regulation Act 2001 as the facilitation of the development and operation of cost-effective airports which meet the requirements of users, having due regard to a range of factors relating to efficiency, safety and sustainability of operations.

The complex nature of airport operations is indicated by the number of factors to be considered, and Aer Rianta believes that it is not possible to establish an absolute priority between them in terms of their application. Thus a suggestion in one submission that the overriding goal of regulation may be reduced to the delivery of lower passenger fares, increased traffic and new routes is a simplistic distortion which ignores the complexity of airport operations, the varying needs of all users and the need for a balance of long-term and short term considerations.

The Commission suggests that a test of economic efficiency should be applied to meet the objectives outlined in Section 33. Economic efficiency is broadly composed of three elements – productive, allocative and dynamic efficiency. The references to economic efficiency made in the majority of responses to CP2/2001 focus primarily on allocative and productive outcomes, and largely ignore the dynamic component.

There is a general consensus amongst airport users and Aer Rianta that economic regulation should allow for the introduction of allocative efficiency in the determination of the maximum level of airport charges. Some airport users suggest that there are present and historic cost inefficiencies in the management of Aer Rianta airports, resulting in productive inefficiencies. Aer Rianta disagrees with this and believes that such perceptions reflect the short-term focus of primary customers, relating to only one dimension of economic efficiency. Ryanair contends, and Aer Rianta agrees, that economic regulation is necessary to ensure future productive efficiency in the operation of the three airports. However, Aer Rianta is aware of the need to balance short-term interests with long-term needs.

In the various submissions, airport users fail to take account of the need for dynamic efficiency, despite calls for increased availability of facilities and higher standards of service. Aer Rianta believes that the test of economic efficiency is appropriate in the application of economic regulation to the Irish airports with the Commission acting as the independent arbitrator, but contends that this requires that a suitable balance between static and dynamic components is maintained.

2.2 Airport Users

Practically every submission has provided a definition of ‘airport users’, many of which were extremely narrow. Ryanair suggests that users primarily mean airlines/freight operators, while the IAIEC also wants cargo operators included in the definition. Servisair further extends the definition to include ground handlers and passengers. Aer Rianta can perhaps take a more objective perspective on this issue. In the context of Section 33 of the Aviation Regulation Act 2001, a broad definition is necessary to ensure that, as discussed by the Commission, economic welfare is maximised through productive, dynamic and allocative efficiency.

The consequence of restricting the definition of users to the narrower group means that the focus of regulation would be reduced to a consideration of productive and allocative dimensions i.e. static elements of efficiency, as the current operators will focus on their immediate needs and costs. Thus the long term needs of all users, including passenger and cargo operators and the wider community of business and leisure interests, could be compromised through excessive focus on the short term needs of the current direct customer base. In terms of the statutory demands on Aer Rianta, there are inherent dangers in such an approach.

This concern that current primary users might focus exclusively on the short –term has been demonstrated in recent years, where the slot allocation process was a function managed entirely by the operators through a system of voluntary coordination. The lack of willingness on the part of the airlines to make adjustments to their own schedules in order to improve the efficiency of use of existing facilities and resources has resulted in the appointment of Airport Coordination Ltd. (ACL) to act as independent slot coordinators reporting to the Commission. In its report for the Department of Public Enterprise, SH&E stated that the ability of ACL to effectively manage the coordination process required that

Airlines behave responsibly in assisting ACL to spread the air transport movement peaks

ACL will no doubt be able to inform the Commission directly of the commitment of the operators at Dublin to deliver on their stated intentions of optimising allocative efficiency.

2.3 Competition

In response to the Commission paper CP2/2001 Aer Rianta stated that it favours the introduction of effective competition in specific sectors of airport services where this is possible, although it acknowledges the limitations of competition in markets with natural monopoly characteristics. However, the responses of airport users suggest that the introduction of effective competition at airports will automatically give rise to efficiency gains and lower average costs. This fails to consider the case of a natural monopoly market. Where a number of airports engage in supplying aeronautical activities in a given market, there is evidence to suggest the cost of production for the provision of aeronautical facilities is likely to be high and it is more cost effective for a single producer to supply the market. Economic regulation is then justified to preserve efficiency and ensure that abuse of market power is not possible. This is the rationale underlying the introduction of an independent regulatory regime in the Irish airport context.

2.4 The Regional Contribution of Airports

Airports make an important economic contribution to the regions in which they are located. They play a vital role in generating economic growth through the development of tourism, and promotion of commercial and industrial activity in a region. Several submissions to the Commission dealt with this issue by focusing exclusively on the regional impact of airports in terms of tourism and low fare access to the regions. While this view is undoubtedly valid, it fails to acknowledge the various indirect and induced effects on commercial and industrial activity in the regional economies. The economic contribution of Irish airports to the regions has previously been assessed by a number of independent studies[2].

It is, however, an issue of some concern that Ryanair, the Irish Hotels Federation (IHF) and the Department of Tourism, Sport and Recreation appear to believe that all tourism is dependent on the availability of low cost carriers, and that all tourist growth in recent years has been attributed to Ryanair. This misconception is a serious one, since it is a precursor to suggesting that some mechanism should be devised to give an advantage to such carriers over and above those received by a full fare carrier or cargo operator. Aer Rianta has already discussed this issue in its initial submission in the following terms:

- Air traffic is composed of several segments and typically only a small proportion of the total passenger numbers relate to tourist inflows. In relation to the Aer Rianta airports the Irish resident segment typically is in the range of 40%-50%, although this figure will be somewhat lower in the case of Shannon Airport with its significant proportion of transatlantic traffic. Overseas resident traffic is broadly composed of three key segments viz. business travel, VFR and holiday travel. CSO /Bord Failte/ NTB figures show that in 1999, only 37% of overseas visitors to Ireland specified holiday travel as their main purpose of visit. When taken in conjunction with Irish originating traffic above, it is clear that only about 20% of total traffic at Aer Rianta airports is inbound holiday traffic.

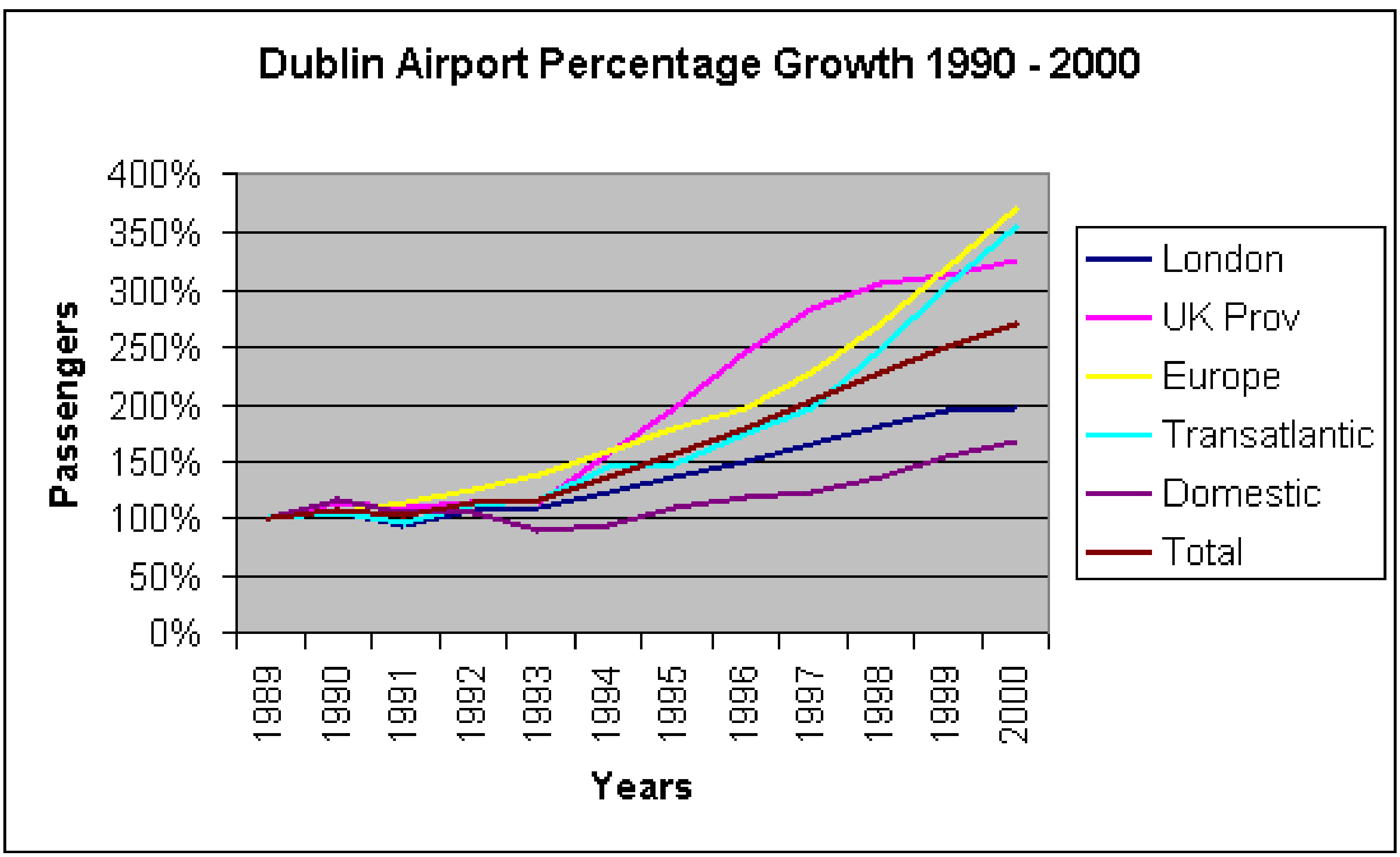
- Within the tourist market, a range of products and services are required to meet the demands of the various types of tourist. These range from the backpacker to whom price is the key determinant through to the visitor at the upper end of the tourist market demanding luxury facilities. It would not be prudent for Ireland to design all tourism products with the needs of only the low spending budget customer in mind, and specifically to design the airports as large under-specified utilitarian facilities would not be consistent with the image that Bord Fáilte is fostering for the Irish tourist industry abroad.

- The proposition has been made that airport charges should remain at their current low level in order to subsidise the non-resident segment of the tourist market. The use of airport charges as a means of supporting the tourist sector is a highly inefficient approach. On examination it is clear that in relation to holiday/tourist arrivals by air, the price elasticity of demand for the air travel component does not exceed –1 as the air travel component must be combined with land product price to determine the overall cost involved to the potential tourist. Irish airport charges form only a small portion of the airfare. The airfare itself is only a proportion of the overall holiday price therefore the likely effect of increases in airport charges on incoming tourist flows is negligible.

- As airport charges are at such a low base level, Aer Rianta's proposed increase in the aeronautical revenue required per passenger, if fully passed onto the travelling public by the airlines would only represent a small increase in the price of an airline ticket and would have no effect on the competitiveness of Ireland as a tourist destination. Failure to invest in and develop Irish airports would, on the other hand, seriously impede the growth of Irish tourism.

- The introduction of efficient pricing signals and reasonable returns will assist in the development of a viable aviation business that receives an appropriate degree of maintenance and upgrading and is able to compete internationally for the necessary capital required for future expansion. This will ensure that in the future Aer Rianta can provide appropriate facilities for both airlines and passengers and will ultimately contribute to the long-term development of the Irish economy, including the tourism sector.

The graph below illustrates the growth rates across a range of markets in recent years, clearly showing that growth has been significant in all markets, including those not served by Ryanair.



Indeed in recent times Ryanair has deliberately concentrated on growth outside of this country, and through its pricing policy on Ireland-UK routes has ensured that it has generally imposed higher prices for people travelling from the UK to Ireland than for the reverse trip.

Aer Rianta agrees with the views of other submissions that it is important to develop traffic in a sustainable and efficient manner. Aer Rianta's commitment to development of sustainable routes can be seen in the introduction of a New Route Support Scheme for 2001, which will support airlines in the initial stages of starting up a new route, through a rebate on landing and passenger fees. This concept has been supported by IATA in its submission. It should be noted that the Competition Authority submitted that non-cost related discount schemes could hinder growth, and indeed 'ossify the position of the largest carriers'. This is indeed an issue, and is one of the reasons why Aer Rianta has not re-introduced a growth discount scheme similar to those operated for a number of years during the mid 1990s.

Aer Rianta is committed to encouraging sustainable growth for both full fare and low cost carriers of passenger and cargo and looks forward to cooperation from the airlines in delivering this outcome.

3 Proposed Framework for Regulation

3.1 Method of Regulation

There is general agreement among airport users that incentive regulation is the most appropriate method in order to apply independent economic regulation at Irish airports. Incentive regulation encourages the airport authority to strive for efficiency gains and to meet the requirements of airport users through a sharing of the derived benefits between all parties. As a result Aer Rianta proposes a modified price cap based on the formula RPI+/-X, with efficiency gains distributed over an extended period between airport operator and users through a profit sharing mechanism.

3.2 Form of Price Cap

There are a number of methods of applying the RPI+/-X formula discussed in the various submissions.

3.2.1 A Total Revenue Cap

The introduction of a total revenue cap will place an absolute cap on the overall level of revenue derived from aeronautical charges. This is an extremely inflexible approach which would eliminate any incentive for growth and investment in capacity on the part of the airport authority, thus damaging the prospects for national economic growth.

3.2.2 A Hybrid Cap

The application of a hybrid cap as suggested by Aer Lingus combines an absolute cap on total revenue with individual caps on different categories of charges. This approach combines the limitations of the total revenue cap and the rigidity of the capping of individual charges. Thus the airport operator has little incentive to invest in increased capacity and is simultaneously restricted in the uses of individual charges to encourage allocative efficiency. Therefore both static and dynamic dimensions of efficiency are adversely affected.

3.2.3 Individual Price Caps

This approach which was advocated by Servisair is difficult to implement in practice as it is both complex to administer and unduly restrictive on the airport authority. Since airports function in a highly dynamic market, the airport operator should be permitted the freedom to adjust individual charges in accordance with commercial and market objectives within an overall average revenue cap in order to optimise allocation of resources. The inflexibility associated with caps on individual charges could potentially reduce the airport authority’s ability to react to market changes thus also reducing dynamic efficiency.

3.2.4 A Tariff Basket

The introduction of the tariff basket approach would allow for the application of a price cap to a weighted average charge derived from weighting individual charges in a basket of aeronautical charges based on their revenue share in the previous period. The tariff basket approach is inflexible and reduces the ability of the airport authority to encourage efficient behaviour. If the tariff basket is inappropriately structured, there is a risk of economic loss to the airport authority and its customers. The tariff basket approach may present difficulties in the context of a new pricing structure for airport charges, as it would be inappropriate to calculate future projections based on historic patterns that are no longer applicable. This is very pertinent in the case of the Irish airports as Aer Rianta in its submission to the Commission outlined its intention to introduce a new pricing structure for aeronautical charges in order to encourage more efficient future use of facilities.

3.2.5 Average Revenue Yield

Aer Rianta, like IATA, favours the introduction of the average yield approach where the price cap on airport charges is applied to an average yield per passenger, as consistently applied in regulation of the three designated London airports and Manchester Airport since the introduction of airport regulation in 1986 in the UK. The average revenue yield per passenger approach encourages growth and the expansion of aeronautical services fulfilling the requirements of users while retaining the ability of the airport authority to define an efficient pricing structure. The average revenue yield per passenger method minimises the restrictions on the airport authority and the burden on regulator and regulatee, enabling an effective and efficient use of airport facilities. This approach is also easily understood and transparent, important considerations for the Commission in implementing a new regulatory regime.

3.3 Regulation as a Group

Aer Rianta strongly believes that regulation of the three Irish airports as a single entity provides the framework for the introduction of appropriate charges, which balance demand and capital expenditure between the three airports, while ensuring economic efficiency. Although it was suggested in one submission that airport charges might decrease at each airport under an individual cap regime, the converse in fact is likely to be the case in the light of the increased costs arising from the heavier regulatory burden such a regime would impose. It should be noted that having the airports regulated as a unit does not imply that airport charges would be the same at each airport.

Aer Rianta agrees with Aer Lingus that the regional policy issues are so significant that it is appropriate to consider those in the context of a three airport group, as discussed in our previous submission. As the airports are so important in terms of regional and national development it is crucial that Aer Rianta is able to take advantages of the economies of scope and scale of operation of a group and that a significant regulatory burden is not added through regulation of the airports separately. The importance of Cork and Shannon to the regional economies has been discussed at length in the first Aer Rianta submission, and has been emphasized by a wide coalition of community interests, from Aer Lingus to the Mid-West Regional Authority and the IHF.

Specifically, group regulation allows Aer Rianta to

- Reap the benefits of networking and economies of scale and scope
- Introduce timely and necessary capital investment at all three airports
- Assist in the development of regional airports in line with government policy
- Reduce the regulatory burden at individual airport level
- Optimise economic efficiency at all three airports

Through the regulatory mechanism, the benefits thus derived will be passed from Aer Rianta to the direct users, and may ultimately be distributed to end-consumers.

4 The Regulatory Till

A consensus emerged among many of the airline users as to the merits of the single till approach in determining the regulatory till. According to airline users, the single till was said to offer the best approach in dealing with the synergies between commercial and aeronautical activities.

The representations made by the airline users were rather one-sided in that they chose to ignore many of the disadvantages associated with the single till approach. This approach has been widely criticised on economic grounds and a definite trend away from this principle is emerging worldwide. The application of the alternative dual till approach is currently under review in jurisdictions such as Australia, Germany, South Africa, US and the UK.

- The single till principle fails to provide adequate price signalling in the airport market as prices do not reflect the true cost of the provision of aeronautical services, resulting in underpricing of facilities, and distorted demand potentially causing congestion. In the case of a congested airport facility, this principle gives rise to allocative inefficiency.
- Investment decisions may be distorted in both aeronautical and non-aeronautical facilities through the application of the single till approach.
- Aeronautical services are exposed to the risks associated with commercial enterprises in a single till environment.
- The single till extends the remit of regulation beyond the confines of aeronautical charges. It allows

the Commission to extend the scope of regulation into commercial and retailing activities, exposing potentially competitive markets to the burden of regulation.

Aer Rianta favours the application of the alternative dual till approach in the determination of the regulatory till. The dual till approach offers a superior level of allocative efficiency in the case of congested airport facilities and provides enhanced price signalling in the airport market. This method allows for airport charges to cover costs incurred directly by aeronautical activities and therefore offers a more cost transparent approach. The dual till approach provides improved incentives for investment in aeronautical infrastructure leading to increased dynamic efficiency.

The composition of the regulatory till provoked widespread discussion. In its submission, Ryanair calls for the inclusion of all revenues, aeronautical and non-aeronautical, generated at a regulated airport. Aer Lingus and the IAIEC believe that it is appropriate to consider only those assets which are required to support aeronautical services, within the context of a single till framework. Aer Lingus specifically suggests that Aer Rianta’s hotel business and international activities be excluded from the regulatory till.

Servisair supports a dual till approach but nonetheless want all airport assets within the regulated Asset Base (RAB). Aer Rianta also welcomes the dual till approach, as it is appropriate that any airport activities operating in a competitive market are excluded from the regulatory till to prevent distortion of a contestable market.

5 The Regulated Asset Base (RAB)

Determination of the value of the RAB is central to the determination of two key components of the overall regulatory revenue requirement: the return of capital (i.e. depreciation) and the return on capital (i.e. the cost of capital). These components typically represent a significant proportion of allowable revenues[3].

In the various submissions made to the Commission, the discussion of the appropriate composition and valuation of the RAB was wide-ranging, and generally related to the position held by the author on the regulatory till.

5.1 RAB Valuation

After the RAB composition has been defined, it is important that the appropriate values are attached to the included assets. This is particularly relevant in the context of a capital-intensive industry such as airports where many assets are relatively long-lived and expensive. Under-valuation of assets and inadequate depreciation provisions will not allow a company to generate enough cash for expansion or replacement capital projects. The cost of capital to the company will be increased, thus deterring capital investment. The decisions on the valuation and depreciation policies are therefore of long term significance.

Aer Rianta has already indicated in its first submission to the Commission that it believes that the appropriate methodology is a replacement cost approach as it provides much more accurate signals regarding the economic costs of provision of infrastructure. In allowing the prices to be based on the actual current costs, allocative efficiency is improved, and this is the element of efficiency most valued by the operators themselves. This approach is the most commonly used by regulators in the UK in regulated industries.

Of the other approaches, the Indexed Historic Cost is superior, in attempting to ensure that the RAB value keeps pace with inflation. However, since the indices used will not precisely reflect the trend in asset costs, it will not be as accurate as the replacement cost approach in signalling the true economic costs of infrastructure provision.

A Historic Cost methodology would mean that the value of the assets bears little resemblance to their current cost, and hence allocative efficiency is reduced. Particular distortions could be introduced with a historic cost model between old and newer assets affecting the balance of charges between them. The use of a historic cost model would not meet Section 33 requirements in terms of ensuring that sustainable development is possible.

In CP2/2001, the Commission has indicated that it intends to apply a test of maximisation of economic welfare to determine regulatory choices. On this basis, application of a replacement cost asset valuation methodology would be the most appropriate choice in terms of its economic signalling potential. Use of an indexed historic cost would be inferior to the replacement cost approach, while a historic cost approach could seriously distort the cost base for Aer Rianta. Thus Aer Rianta strongly argues against the application of an historic cost methodology in the valuation of assets for regulatory purposes.

6 Cost of Capital

Aer Rianta is of the opinion that the rate of return allowed to a regulated company should be equivalent to its cost of capital on new investment. The cost of capital should be calculated by use of the Weighted Average Cost of Capital (WACC) methodology. The use of the Capital Asset Pricing Model has been widely supported by respondents where discussed as the most appropriate option for estimating the equity component.

It should be noted that if the rate of return is set at a level which is lower than that available on the open market, this will discourage potential investors. This point is recognized by IAIEC in its submission.

There have been suggestions from a number of respondents that the cost of capital allowed to Aer Rianta should be little higher than that offered for government bonds. Aer Rianta strongly opposes this suggestion as inappropriate since there is no government guarantee of Aer Rianta debt, and investors seek higher rewards for investment in Aer Rianta than those obtaining for government bonds. The recent debt raised by the company can confirm this position.

For the purposes of estimating a WACC for the current review, it is appropriate to treat Aer Rianta as if it were a private sector enterprise and to treat its regulated activities as stand-alone, commercially orientated, and investor owned. Aer Rianta has a mandate to operate as a commercial company and the Government has clearly indicated that it does not provide State support. All debt and the company's credit rating is secured on this stand alone basis. Any other interpretation would imply that the State would carry the risk which is reflected in the differing rates between the sector generally and government bonds. The risk does not disappear due to government ownership, but is either borne by the users of the assets or the shareholders. Were the State to accept a lower return than the market as a whole, it could be contrary to EU Competition Law on State Aids. The European Commission is shortly to launch a study into competition between airports and the application of State Aid rules to the airports sector.

7 Capital Investment

Airport growth is greatly influenced by the ability of the airport authority to plan for the proper development of the airport in the long term - typically 20-40 years. As airports comprise vital elements of national infrastructure, the adoption of a long-term view is critical to ensure that they are properly integrated into the wider planning process i.e. National Development Plans, County Development Plans etc. A long-range plan ensures that the airports ability to expand and develop is preserved. This contrasts with the more short-term focus of the airlines that have the ability to move or sell their aircraft in response to market conditions to any location.

Investment plans are critical to decisions taken by the regulator on price regulation. The magnitude of capital spend in an airport context has profound effects on the cash flow and capital structure position; its timing affects the operational throughput of the airport; and the cost effectiveness of the capital programme will affect the airport's self-financing capability and impact on user charges. The starting point for the capital plan is the traffic forecast, which must be developed in a robust and systematic manner.

7.1 Traffic Growth

In its initial submission, Aer Rianta outlined its approach to forecasting. Other submissions presented an interesting range of views in relation to the drivers of traffic growth. Ryanair expressed a view that traffic growth is primarily influenced by the availability of low charges or discounts although elsewhere it also notes that the Ireland-UK market is maturing. This view is directly at odds with the Aer Lingus and IAIEC perspective that demand is, in fact, rather inelastic. Ryanair also alleges that the withdrawal of Virgin Express, AB Airlines and Cityjet from a range of routes is due to high airport charges, which suggests a surprising lack of knowledge about the recent history of these airlines.

7.1.1 Current Capital Investment Programme

Aer Rianta, in its first submission, outlined the reasons for the need for capital investment in its facilities at the three Irish airports in the recent past and the immediate future, which arises from a combination of the historical under spend in the mid 1990s due to externally imposed restrictions and the extremely high growth in traffic in recent years. Any further delay in investment would impose greater penalties on all airport users.

One submission suggested that Aer Rianta should sell all assets that could be considered to be non-core to fund capital investment, and disallow recently incurred capital investment. These views themselves clearly illustrate the need for an independent perspective, which takes account of the future needs of all customers as opposed to the immediate cost-focused horizons of some airport users. They also vividly point out the dangers inherent in assigning to a small number of large primary customers a controlling interest in the development of the airport, where economic welfare of the community will be subordinated to the sole need to derive value for airline shareholders.

Some submissions questioned the rationale for investment undertaken by Aer Rianta in recent years and simultaneously complained of inadequate facilities. This somewhat inconsistent view of Aer Rianta airports is not shared by SH&E. In its recent review of Dublin Airport commissioned by the Department of Public Enterprise, SH&E stated that the airport was operating "near its absolute capacity". As SH&E point out, there are difficulties in bringing capacity on stream where demand is high, and this was illustrated during the construction and commissioning of the 6-bay extension at Dublin Airport, which because of the delays imposed externally came on stream during a busy peak period, itself causing some temporary congestion effects.

7.2 Consultation

Several submissions discussed consultation in relation to Aer Rianta over time. There was however, a degree of confusion as to the nature of a consultative process in relation to capital investment. It is not practical to suggest that airport users could be brought to a consensus in relation to capital investment, given the diversity of requirements and interests amongst the wide spectrum of customer types at Aer Rianta airports. As has been discussed at length in earlier sections, it is also inappropriate that the current primary users should be awarded any ability to veto future development since the focus of these users is exclusively on the short-term cost implications, with little regard to the long-term needs of the wider community in relation to airport development. It thus follows that similar rebuttals apply to the more extreme suggestion from Aer Lingus that users with a substantial market position should be in a position, based on this market power, to influence the final outcome of the consultation process.

Despite assertions to the contrary, Aer Rianta has consulted extensively in relation to capital expenditure over the years with its customers, particularly in relation to Pier C and the 6-bay extension at Dublin. Plans have been discussed with airline personnel at all levels, including Chief Executive. This has admittedly been made a more difficult process due to frequent personnel changes in recent years among our customer airlines, and varying degrees of participation in consultative fora by some carriers.

In the future Aer Rianta's intention is to continue to engage all customers in a constructive process of dialogue on a range of issues, through a series of working groups focussing on specific areas of interest to users. This will assist Aer Rianta in the efficient and effective management of airport resources now and in the future.

8 Efficiency Effectiveness and Benchmarking

Aer Rianta fully supports the concept of benchmarking, despite its acknowledged information asymmetry, discussed in some detail in the IATA submission. It should, however, be borne in mind that benchmarking is only a guide to comparative performance and is not a prescription for improvement. The Aer Rianta submission proposed that the Commission should apply benchmarking at the level of individual airport services and activities. Given the complexities and potential problems associated with international benchmarking of airports, also acknowledged by Aer Lingus, IAIEC and IATA, it is inappropriate to attempt to engage in overall comparisons of the totality of operations.

This is borne out when the Servisair proposals for comparator airports (based solely on the basis of passenger volume similarities) are examined. Shannon Airport's proposed comparator Turin engages in direct passenger, aircraft and cargo handling in addition to air traffic management services, a very different range of activities to those undertaken at Shannon. Similar problems exist in relation to the comparators suggested for Dublin and Cork Airports. An overly simplistic approach to benchmarking as suggested by Servisair or Ryanair can result in misleading comparisons between airports with few operating similarities in common, and at differing stages in terms of their developmental cycle. The use of inappropriate comparators in deriving a price cap for airport charges could lead to economic inefficiency in its operations and potentially to an inability on the part of the airport to fund its required investment programme.

Aer Lingus has suggested that it should have a role in designing and interpreting any airport benchmarking process which might be implemented by the Commission. Aer Rianta believes that airlines do not have the necessary expertise in operating airports to allow them to act as expert advisers in this area.

9 Quality of Service

Aer Rianta, in its submission, accepted the principle of delivering the appropriate level of service to its customers. However, because of the heterogeneity of its customer base, definition of basic service standards is a complex matter. Aer Rianta believes that it would be inappropriate to develop the airport with the demands of any single customer type in mind - either low cost or full fare. The role of the airports in modern Ireland is a pivotal one, as they are the gateways to a dynamic and high technology economy and act as catalysts for further development at a regional level. It is appropriate that the key focus of service quality should be at the level of the individual passenger.

It should be noted that airports are not a self-contained system. They are part of an integrated system of activities in which each part impacts and depends upon the others. The overall performance of processing passengers, freight and aircraft depends on the collaboration of "partners" (e.g. airlines, handling agents, customs, immigration and aerodrome navigation services). Deficiencies in service quality are frequently attributed to the airport authority even when responsibility for delivery of the particular service does not rest with it.

A key issue for consideration is the degree of influence and control that the airport can exert over the service standards where the product/service is being delivered by the airlines and their handling agents. This is an issue which has not been acknowledged by the airlines and handlers as, while they demand high standards of service and facilities in their submissions, they were reluctant to co-operate with Aer Rianta in the implementation of new Rules of Conduct to assist in the delivery of consistent service standards to the travelling public.

This dichotomy was further illustrated at Dublin Airport in the past 18 months by the airlines' unwillingness to adhere to voluntary slot control measures. The uncoordinated approach to flight schedules planning led to over-scheduling by the airlines and to the overloading of facilities at certain peak times, particularly weekends. Airlines are unwilling to move to a co-ordinated arrangement as it curtails their scheduling freedom. Ultimately, the impact of such airline behaviour is to push Aer Rianta to deliver capacity to meet heavily peaked demand – a most inefficient and costly approach. ACL has now been given the responsibility for independent slot co-ordination at Dublin Airport for 2001 and will report directly to the Commission for Aviation Regulation.

Contrary to the views expressed by IAIEC, Aer Rianta is strongly of the view that it would be inappropriate for the Commission to become directly involved in determining the level of service standards at regulated airports. This would require an unwarranted degree of involvement by the Commission in the day-to-day operations of the airports and there is no precedent for the adoption of such an approach by the Commission in any other jurisdiction where airports are subject to economic regulation.

Aer Rianta gives a high priority to service quality issues. However, it must be clearly recognised by all parties that delivery of service standards implies investment, and the costs of this investment must ultimately be borne by users. Thus it is inconsistent to simultaneously demand increasingly high standards of services, lower investment and reducing airport charges.

10 Principles of Airport Charges Structure

Aer Rianta outlined in some detail in its preliminary submission that it intended to put in place a new structure for airport charges designed to provide good economic signals to users regarding use of infrastructure. This would involve six separate charges,

- Landing/take-off
- Parking
- Airbridge
- Passenger Terminal Charge
- Security
- Immigration and Naturalisation Services.

These charges will be structured so as to reward efficient users of facilities. Peak charges will be applied where there are congested periods for runway and terminal charges, to signal to users the costs of increasing congestion. The charging structure will be similar across the three airports, although some differences in detail may exist, and levels will reflect the cost base at the individual airports.

A transparent set of charges is thus proposed which is designed to encourage users to optimise use of efficient resources. The application of the charges will be non-discriminatory, and broadly cost-reflective. Externally imposed costs will be easily identifiable. This structure is flexible enough to allow for the features of each of the three airports to be taken into account.

Current charges are extremely low by international standards, as evidenced by objective international studies. Aer Rianta is very anxious to put in place the facilities to allow the airport and its environs to grow for the future. Comparing, as Ryanair does for charging purposes, Aer Rianta airports to very small under-utilised airports into which it operates like Dinard or St Etienne, ignores the fact that many of these airports are supported by regional or local authorities. They have written off assets and spare capacity and the local community or authority subsidises the operation on the basis of the knock-on benefit to the community. In contrast, Dublin, in particular, is several orders of magnitude larger than the majority of these airports and Aer Rianta operates three stand-alone commercial airports without Government subvention. Thus charging comparisons of this kind are spurious and misleading.

While Ryanair is anxious to see a charging structure which rewards efficient use of resources, it is nonetheless against peak charges, despite their obvious advantages in this regard. Ryanair wants differentiated charges, unlike Aer Lingus and IATA which strongly oppose such an approach. This divergence in views illustrates again the difficulty in proposing a solution which all operators will accept willingly, and shows that even focusing exclusively on the allocative efficiency issues would not ensure their support.

It is worth noting that Aer Lingus does recognise the need for Aer Rianta to retain pricing flexibility, and that it agrees with Aer Rianta that the Commission should not directly specify how Aer Rianta should charge for different services. Aer Rianta agrees, as this will permit a charging structure to be put in place which allows economic efficiency to be maximised.

10.1 Costs Covered by Airport Charges

Aer Rianta submitted that all costs pertaining to the regulatory till must be covered through airport charges, including the allowed rate of return. In general, the more objective submissions concede this point, and agree that in order for the airports to be able to meet future demand this is a necessary prerequisite, as discussed by the Commission in its paper CP2/2001. Servisair and IAIEC wish to see the 'user pays' principle applied, although it is inevitable the costs of common infrastructure components must be recovered from a wide base. This is broadly consistent with the Aer Rianta approach as outlined in the previous submission.

Ryanair has incorrectly suggested that a 'regulatory vacuum' prevailed since the announcement of the impending appointment of the Commission in 1999, which permitted Aer Rianta to engage in unwarranted expenditure in the interim. It must be emphasised that expenditure in the intervening period was part of the ongoing Capital Expenditure plan, which in previous years had been consulted on and discussed in detail with the airlines, and which was generally accepted as very necessary. It was approved by the Minister for Public Enterprise and predecessors and confirmed as necessary by external consultants, the most recent study being that undertaken by WDR/AIB/SH&E.

The need for these facilities was, in fact, corroborated by subsequent complaints from the operators about terminal congestion during 2000 at Dublin Airport during the commissioning of the new facilities. It would have been unacceptable for Aer Rianta to retain facilities at the 1998 level, given the traffic growth rates at the time, and it would be unsound to use the 1998 cost base as the reference point for charges from 2001 onwards. An arbitrary decision to disallow necessary expenditure would be inconsistent with the stated objective of maximizing economic welfare, and would certainly have implications for any current and future investors/ debtors, with a consequent effect on the cost of capital. This is alluded to in the Competition Authority submission, which states that it is important that "the correct incentives are given by the regulatory regime to increase capacity….in an efficient manner".

10.1.1 Assets in the Course of Construction

One of the clear conclusions which can be drawn from the airline and handler submissions to the Commission is that the focus of primary users is on the short-term horizon, as opposed to the long-term focus of the airport authority. Aer Rianta has already emphasized that for airports it is necessary to consider the dynamic elements of economic efficiency i.e. the long-term ability to introduce capacity to meet demand. This imperative is articulated in the Aviation Regulation Act 2001 itself, as well as in statutory objectives outlined in the Air Navigation and Transport (Amendment) Act 1998.

Aer Rianta has discussed how it is necessary to recover the costs of Assets in the Course of Construction (AICC) to ensure that investment is undertaken in a timely fashion as demand requires. The application of a rigid policy of allowing cost recovery only for assets in use would result in capital investment being skewed towards the end of a regulatory period, with consequent risks of late delivery of capacity and price fluctuations.

11 Conclusion

Aer Rianta has commented on the key issues of substance addressed by various submissions put forward to the Commission in response to the Commission paper CP2/2001. In doing so, it has attempted to highlight both the areas of consensus and the areas of disagreement, discussing in detail the factors which should be the primary criteria in establishing the regulatory framework for the regulation of airport charges in Ireland.

A number of submissions contained errors of fact or misinterpretation of data which Aer Rianta addresses in the attached Appendix 1.

Appendix 1

Aer Rianta wishes to address a number of the significant inaccuracies and misleading statements which it noted in other submissions to the Commission.

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Comparative Airport Charges

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- Ryanair states that UK airports keep their costs low and meet the needs of users whereas Aer Rianta costs and charges are said to be high. UK airports are generally speaking very well run and very competitive in relation to their peers – especially the BAA airports. However, there is more than ample evidence in the public domain to prove that airport charges at the major UK airports are significantly higher than airport charges at Aer Rianta airports.

In 1999 PWC carried out a comparative analysis for Aer Rianta of airport charges and concluded that there is one clear-cut way to establish real comparisons between airports, i.e. to compare average aeronautical income per passenger. This measure clearly takes into account discounts, surcharges and all the other aspects, which render comparisons difficult. The resulting table is shown below.

Table 1 Revenue Yield per Passenger at Selected European Airports 1997

Airport	**Revenue Description**	**Average revenue per passenger (IR£)**
Vienna	Aviation revenue	16.87
Birmingham*	Aeronautical revenue	9.98
Manchester*	Aviation income less baggage and freight	9.23
Aberdeen*	Airport and other traffic charges	8.49
Edinburgh*	Airport and other traffic charges	7.70
Glasgow*	Airport and other traffic charges	7.64
Frankfurt	Airport fees	7.42
London Luton*	Traffic	6.30
Heathrow*	Airport and other traffic charges	6.02
Geneva	Aeronautical revenue	6.00
Munich	Landing fee revenue	5.96
Schiphol	Airport fees	5.47
Hamburg	Take-off and landing charges	5.22
Dusseldorf	Airport charges	5.18
ADP	Aviation fees	4.78
ANA Portugal	Traffic income	4.65

Copenhagen	Traffic revenue	4.62
Gatwick*	Airport and other traffic charges	4.58
Stansted*	Airport and other traffic charges	4.46
Milan	Airport charges	3.72
Dublin	Net aeronautical charges	2.80

*Financial year ending 31 March 1998

Source: Airport Annual Reports

- Clearly the average charge per passenger at these UK airports is significantly higher than at Aer Rianta airports. Though the average level of discount at Aer Rianta airports is now much lower than when PWC conducted its study, the average charges in comparator terms would not be significantly changed.

In addition, other international comparisons based on detailed studies by professional research organizations working for third parties confirm that Aer Rianta airport charges are very low compared to its international peers. The most thorough and professional study of which Aer Rianta is aware is the one carried out by the Hague Consulting Group on behalf of The Netherlands Directorate General of Civil Aviation and the top line results from its 1999 study are shown below.

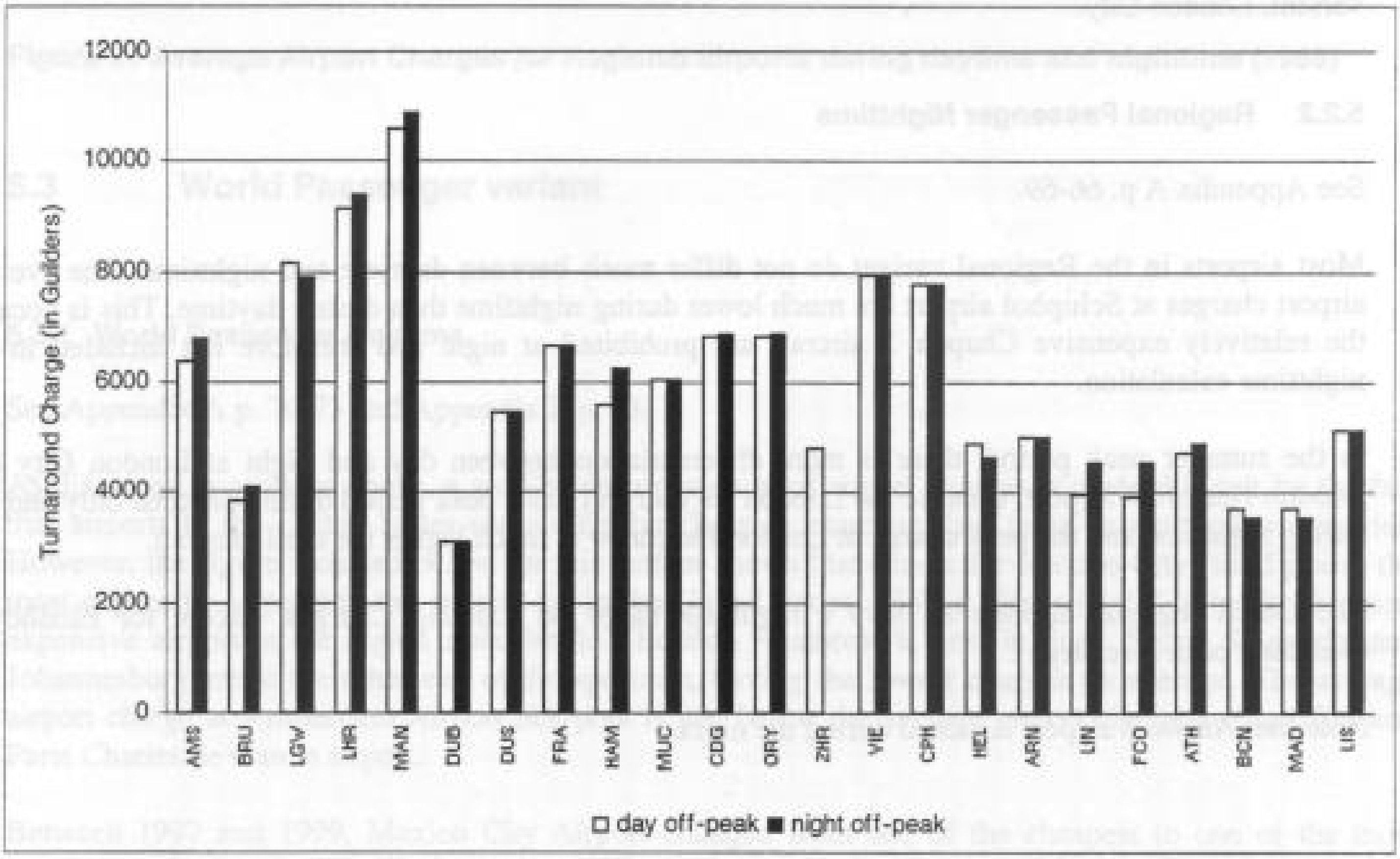

Figure 20 Average Airport Charges for European airports during daytime and nighttime (1999)

· When adjusted for exchange rates and based on its average payment to Aer Rianta during the year, Ryanair claims, based on the ratios provided in its submission that in 2000 it paid -

- UK£1.61 per passenger to Stansted Airport
- UK£1.93 per passenger to Manchester Airport
- UK£2.79 per passenger to London Gatwick

and that it paid less than UK£1.57 per passenger to Teeside, Leeds Bradford, Liverpool and Bristol airports. These levels of charges would represent significant discounts from the published charges of these airports. UK airports are clearly charging Ryanair much less than average aeronautical charges, as illustrated in the PWC table above. Based on Ryanair's own claims about what it pays at these airports, a cross-subsidy to Ryanair from other users is implied.

- Ryanair also makes reference to the development of Stansted as a “low cost airport “ but this is a seriously misleading claim. Stansted during the 1990’s was by far the highest cost per passenger airport operated by the BAA. The 1996 MMC review demonstrated the scale of the losses per passenger at Stansted which in 1994-1995 amounted to UK£11.64 per passenger. These losses were covered by the profits earned at Heathrow and Gatwick. This was a reasonable strategic decision by the BAA given the need to develop new capacity in the South East of England but only a single London Airports operator of the scale of BAA could have contemplated the level of losses incurred at Stansted and then only in the context of the long term perspective which airport companies utilise. To put this further in perspective, comparable losses for Aer Rianta would amount to over UK£200 million per annum at 2000 traffic levels

- Ryanair claims that Aer Rianta lobbied the Department of Public Enterprise to allow the introduction of full coordination so as to facilitate the introduction of a peak pricing structure. This is, of course, incorrect as confirmed in the SH&E report commissioned by the Minister for Public Enterprise which states that coordination of the airport was warranted on the basis of the level of usage of airport systems and sub-systems. The issue of peak pricing is unrelated to the coordination issue.

Phasing out of Discounts

· Aer Rianta introduced a number of growth incentive schemes during the 1990’s, which were designed to stimulate traffic growth at a time when the airports had spare capacity and while duty free sales generated high earnings for the company. All of the schemes were scheduled to be phased out over specified fixed terms and carriers were advised of these terms ab initio. There is no basis for claiming that these discounts were in any way permanent or intended to be permanent. The underlying charges during the entire period were the published tariffs of 1987, which did not change throughout the decade.

· Aer Lingus claimed in its submission that Aer Rianta’s discount schemes were discriminatory, but this is not correct. The airport charges and discount schemes applied by Aer Rianta are non-discriminatory. These schemes have been published by Aer Rianta and have been available to all carriers on equal terms.

Capital Investment

- It is incorrectly claimed that Aer Rianta built Pier C as an expensive alternative to Pier D. In fact, Pier C was planned in advance of Pier D and was set out in the 1981 Master Plan for Dublin Airport. Pier C comprises a much greater range of facilities than that proposed for Pier D which was designed to be simply a gates lounge. The amount quoted for Pier C by Ryanair was incorrect and includes expansion of the old 8-bay terminal with an original design capacity of just seven million passengers. The project included such facilities as an extended and reconfigured baggage hall with new belts, extended departures and immigration halls and retail facilities. None of these elements were specified as part of the original Pier D proposal and were a necessary development of the main terminal to cope with the recent level of traffic growth.

- Ryanair makes an astonishing claim that Aer Rianta spent £95 million at Shannon in 1999, whereas the actual capital investment at Shannon Airport in that year was £24 million. It has also been suggested that there is an enormous differential of £45 million between the costs of Piers A and C, which is based on inaccurate and incomplete data. The differential is in fact quite modest, after allowing for the significant difference in functionality and facilities discussed above.

- It should be noted that no cross-subsidy from aeronautical income to GSH or ARI has occurred contrary to claims made in other submissions.

- Aer Rianta agrees with Ryanair that sustainability of airport operations is a key criterion in ensuring that Aer Rianta's Irish airports continue to be appropriately developed, but wants to stress that this requires the airport authority to be permitted a rate of return which ensures that further capital investment can be funded.

- Comparisons with systems such as Gatwick ignore the fact that such airports have invested heavily in secondary runway facilities (such as six rapid-exit taxiways as compared with one at Dublin), and the fact that the traffic mix at Gatwick is very different. The IAA aircraft separation rules are an important determinant of runway capacity, and these are outside the control of Aer Rianta.

Aer Rianta Forecasts

It is also asserted that the Aer Rianta forecasts were 'attacked' by airlines. This is misleading.

- At the recent customer consultation forum at which Aer Rianta outlined its forecast methodology and results in detail, Ryanair enquired about customer consultation in its preparation, to discover that Aer Rianta had asked for and received input both from Ryanair and other carriers directly or through the airport marketing departments.

- Aer Lingus subsequent to the meeting asked about the degree of discussion in relation to Aer Lingus fleet, route and growth plans, and were informed that a number of meetings and discussions were held with Aer Lingus Marketing and Fleet Planning personnel as part of the preparation of the forecasts presented.

- Some Cargo operators indicated that they believed that the cargo growth rates were too low, and Aer Rianta committed at that meeting to discuss the growth rates in detail for the preparation of the next official forecast.

Tourism

- Aer Rianta shares with the IHF the view that tourism is important to Ireland and that competitive access is important to the success of the tourist industry. However, it fundamentally disagrees with the underlying assumption of the IHF submission that the provision of airport services at below cost is desirable for the development of tourism

Subsidising incoming tourists, whether through the provision of free capital or by any other means, would require the ‘wasted subsidy’ of four times as many travellers. Indeed the intriguing aspect of the IHF proposal is that it would also support Irish holidaymakers who choose to holiday abroad rather than in Ireland. The proposal also requires that taxpayers who do not travel by air and who cannot afford to travel at all subsidise those who do. A state subsidy for airport services would distort the market for transport services and specifically create an imbalance between air and surface modes, contrary to competition law.

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[1] Aviation Regulation Bill 2000 Second Stage Speech for Seanad by Minister for Public Enterprise Mary O’Rourke, 17th May 2000.

[2] Moloney R., Garhart R., O’Leary E., Donnellan T., Twomey M., *The Economic Value of Cork Airport: An Input Ouput Study of the impact of Cork Airport on its Catchment Area, Report for Aer Rianta*, Cork 1997

Tucker A., *Shannon Airport Impact Study, Report for Mid-West Regional Authority*, 1997

Meyler A., *The Social and Economic Impact of Dublin Airport, Report for Aer Rianta*, Dublin 1995

[3] For example, in the case of the recent transmission price control review of the National Grid Company in the UK, the depreciation allowance and the return on the capital each represented approximately a third of allowable revenues.