Introduction to Aer Lingus' response to Consultation Paper

Aer Lingus welcomes the opportunity to contribute to the issues raised by the Commission in the Consultation Paper on Economic Regulation of Airport Charges (CP2/2001).

This review is timely. In recent years, charges have risen while service quality has fallen. The ending of Aer Rianta's discount scheme has resulted in a large increase in effective charges, even if the headline tariffs have not changed. This discount scheme itself illustrates some of the problems that may arise in the absence of effective regulation. While we welcome lower charges, the scheme was discriminatory in its treatment of different airport users. An independent determination of both the overall level and structure of airport charges is needed to ensure that all airport users face charges relating only to the efficient costs of providing the services they require.

We support the single till, which is the most widely-accepted approach to dealing with the synergies between commercial and aeronautical activities in airports across the world.

An independent review must, however, do more than simply set up a scheme for passing Aer Rianta's costs on to passengers. As the Consultation Paper makes clear, this is also an opportunity to examine Aer Rianta's past and existing efficiency, its future investment plans and its approach to consultation with its customers. In our view, many of the largest investment projects undertaken in recent years have not provided value for money. Proper consultation with Aer Rianta's customers would have resulted in better value for money but our views were ignored. Future plans must be better targeted on airport customers' needs if service quality is to be maintained as traffic continues to grow rapidly.

The establishment of the Commission and this first independent price control review provide a unique opportunity to reverse this deteriorating situation. The approach taken at this review and the incentives for efficiency it provides will affect Aer Rianta's behaviour over a longer period than just the five years of the next price control. The form of economic regulation adopted at this review will send signals about the Commission's intentions in the longer term. If incentives are weak, or if Aer Rianta is given incentives which reward inefficiency, it will be hard to reverse the decline at subsequent reviews.

Any solution to the problems facing airport users will necessarily be complex but we believe that the answers lie in three key principles:

p The regulator should set clear guidelines to prevent price discrimination. All charges listed in Appendix A should be regulated. The Commission needs to regulate charges effectively to ensure that they are cost-reflective. It should also allow the airport users who pay those charges to be consulted on the tariff structure and any changes to it.

p Airport users must not be required to pay for inefficiency. Excessive costs of operation, service quality below expected standards and an inflated asset base due to inefficient past investments should be penalised through lower charges. Future investments should only be approved if they are timely, necessary and efficiently undertaken.

p Aer Rianta needs stronger incentives to listen to its customers. We propose a dynamic consultative forum for users to approve investment decisions and enforceable Service Level Agreements to promote the provision of service quality to a high, defined standard. Steps to introduce these must be initiated before the price review is complete, while Aer Rianta is faced with regulatory alternatives. This requires the establishment of a formal relationship between airports, airlines and the Commission.

Structure of this response

We provide responses on each of the 40 questions contained within the Commission's Consultation Paper CP2/2001. We have, however, restructured the order in which we discuss them to avoid repetition. Several key themes – such as the need to disallow inefficient costs, or to initiate effective consultation on service quality and investment – apply to a number of the Commission's questions. Our responses below are therefore presented under the following broad headings:

- Process for the price control review
- Statutory objective
- Form of price control
- Structure of charges
- Competition in provision of Airport Services
- Determining the cost base
- Assessment of efficiency; and
- Service quality: the need for enforceable agreements.

We provide cross-references to the question numbers in the Consultation Paper[1], in the text and separately in an annex.

Process for the price control review

The Commission is committed to a relatively short timetable for this price control review. We have no objections to this timetable. Sometimes it may be better to have an intensive consultation process and quick decisions, rather than delay decisions as increasingly esoteric arguments are deployed on all sides of the debate.

We note, however, that regulators often take a cautious approach and find themselves surprised (in retrospect) by how well companies respond to efficiency incentives. The performance of many of the privatised utilities in the UK, for example, was much better than had at first been expected. We believe that Aer Rianta's operations and cost base are inefficient and therefore that there are substantial cost savings to be identified through benchmarking. The Commission should try to avoid being over-cautious and should critically examine any cost projections that Aer Rianta submits.

Interim price review

The Commission has proposed an interim review of the price control after two years. The insurance provided by this interim review against a settlement which is unfair to Aer Rianta should further strengthen the regulator's hand in deciding to act against inefficiency. We suspect that the interim review would result in, if anything, a tightening of the control and we therefore support it. We also note that price controls can be re-opened in exceptional circumstances. In our view, circumstances that should trigger such a review include:

· replacement of the existing bilateral agreement with the US and Canada; and

· any proposals for substantially changing the role of airlines at Aer Rianta's airports – such as allowing airlines to own and operate terminals, or other facilities.

The views expressed in this note apply to the current situation and would not necessarily apply if these events were to occur.

Mechanisms for effective consultation must be in place before the price review is complete

Later in this document, we provide our views on benchmarking. Although we recognise the practical difficulties involved in rigorous benchmarking, we believe that such an exercise is essential given the clear evidence of Aer Rianta's inefficiency. At present, there is no consultation period proposed between submission of responses by interested parties to the Consultation Paper and the statutory consultation on draft price controls. If the Commission does undertake a benchmarking exercise, we would like to be involved in assisting with the design and interpretation of the analysis. More generally, we believe that airlines and other interested parties should have an opportunity to comment on any benchmarking results before they are translated into draft price controls. This additional consultation would make the benchmarking exercise more robust.

Throughout this response, we emphasise the need for more effective consultation between Aer Rianta and its customers. We propose that a forum of customers should be consulted on all significant changes to pricing structures and on investment plans. This forum needs the backing of the regulator if it is to have teeth. Similarly, our approach to quality regulation is based on establishing effective Service Level Agreements (SLA's) between airlines and Aer Rianta. Again, we will need regulatory support to counter the monopoly power possessed by the airport operator, if we are to achieve agreements with effective penalties for poor performance.

Work on implementing this forum and the SLA's should begin now, while the price control review is in progress. Many regulatory decisions will depend on whether Aer Rianta's customers are able to influence the airport operator. If early progress is not made on this matter there is a danger of concluding the price review on the assumption that effective consultation will be implemented, only to see such consultation watered down or delayed. We need the threat of regulatory intervention to force Aer Rianta to listen directly to its customers. We therefore urge the Commission to take early action to initiate such a process.

Statutory Objective

Q.12

As the Commission has not spelt out how it "will aim to determine the extent to which reliance on each of the factors maximises economic welfare from the airport" it is difficult to address this specific question. However our thinking in relation to each of the ten specific factors is covered elsewhere in this document in response to other questions raised

Form of price control

Incentive regulation versus rate-of-return

Q1, Q2

We strongly support incentive regulation as the appropriate form of price control. Aer Rianta needs to be given incentives for cost reduction and service improvements. Rate of return regulation provides no incentives for cost reduction and is likely to lead to excessive investment (”gold plating”). We recognise the need for necessary investment to improve service quality but the question is not whether there should be stronger or weaker investment incentives, broadly defined. Rather, Aer Rianta should have an incentive to invest *efficiently:* in a way that reduces long run costs to customers or provides service enhancements that its customers actually value. We therefore firmly support CPI-X and see no reason why other alternatives should be examined.

We note that incentive regulation alone may not be enough. Aer Rianta is not a fully commercialised body with profit maximisation as its sole objective. We therefore see a need for Aer Rianta’s customers, and the regulator, to monitor and influence its decisions, particularly regarding pricing structure, investment and service quality. Otherwise, it may be influenced by non-commercial considerations. We discuss these issues in more detail in later sections.

Structure of charges

Price differentials should not re-introduce discrimination

Q3, Q9, Q10

We are not clear what powers the regulator intends to use to determine Aer Rianta’s pricing structure. We would appreciate clarification on this issue. In our view, the regulator should lay down guidelines to prevent discriminatory pricing structures and require consultation on major changes. It should not directly specify how Aer Rianta should charge for different services.

Generally, we are concerned that providing Aer Rianta with complete freedom to determine its own pricing structures could lead to discriminatory pricing behaviour. In the past, Aer Rianta has introduced discount schemes which substantially favoured some airlines over others. We would not want to see such discrimination being re-introduced using spurious arguments of “economic efficiency”. We recognise the need for Aer Rianta to have some price flexibility and we do not want the regulator to be over-prescriptive in this area. We would, however, like to see effective consultation and regulatory scrutiny over any significant price differentials that Aer Rianta might seek to impose between carriers.

Ramsey pricing is discriminatory

We object to Ramsey pricing because it constitutes price discrimination. In the example given in the Consultation Paper – higher charges for services used more by business travellers – there is no obvious cost differential to justify a charge differential. Nor is the service provided better – except for special services such as fast track, for which an additional charge is already levied. We further believe that

Ramsey pricing is contrary to EU and Irish competition law.

Peak/off-peak differentials are likely to be ineffective

Peak/off-peak differentials may have theoretical attractions but we have strong doubts about whether any benefits would be realised in practice. Higher prices at peak will increase efficiency only to the extent that they cause changes in customer behaviour. There is good evidence that the price-elasticity of demand is too low to produce any significant benefits from acceptable price differentials[2]. Faced with higher airport charges at peak times, most passengers will not choose to alter their journey times. Furthermore, airlines have little flexibility to respond to these price signals by changing flight schedules, since those schedules are tightly constrained by the availability of slots throughout the network and the need to maximise aircraft utilisation across that network. This is particularly true of airlines using the airport in question as a hub.

We would therefore expect to see little or no reduction in aircraft load factors at peak times as a result of premium prices at those times, and almost no change in aircraft movements.

The theoretical attractions of peak-load pricing have no merit whatsoever unless they result in changes in behaviour. In our view, the most effective response to peak congestion is for Aer Rianta's investment and operating decisions to be targeted on improving service quality when it matters most. The best way to achieve this is through more formal consultation with airlines. If, after this, Aer Rianta's customers still need to contribute to the solution, direct mechanisms such as slot co-ordination are likely to be more effective than peak pricing.

The three airports should be regulated together while constraints remain on airlines' choice between them

Q7, Q8

If airports are regulated together under a single price or revenue cap, Aer Rianta can be expected to cross-subsidise less congested airports from charges collected at more congested airports. This may promote efficient use of resources if passengers and airlines perceive the airports as being substitutes but it may be discriminatory, in that charges will not be cost-reflective.

If airlines were free to choose between Irish airports, we believe that prices should be cost-reflective – implying that there should be separate caps. However, the use of Shannon Airport required by the existing bilateral agreements between Ireland and the USA and Ireland and Canada reflects Irish Government policy on regional development and modifies decisions away from the commercial optimum. Consequently, all air travellers should contribute to the costs of this policy. Therefore, while the existing bilateral agreements remain in place, we support the idea of regulating all three airports under a single cap.

We believe that some of the historical investment costs at airports represent inefficient, excessive construction. Inefficient costs should never be recovered in airport charges. We return to this issue in a later section.

Charges for different services should be regulated separately

Q9/Q10

We expressed concern above that allowing Aer Rianta to rebalance charges freely could result in discriminatory pricing. This has happened in the past and we are aware of the pressures on the airport operator to produce a pricing structure that favours certain of its customers. The same concerns arise if Aer Rianta is given freedom to meet a single revenue cap by rebalancing between the five different charges. Different airlines use different services (for example, some have little or no cargo operation) and the airport operator may opt to respond to lobbying (rather than acting in the interests of all airport users) if given the freedom to alter the balance of charges. We therefore support caps on individual charges for each of the five categories set out in paragraph 4.1 of the Consultation Paper.

Aer Rianta should, of course, have the freedom to offer transparent discounts, based on objective and non discriminatory criteria, under these caps. The price control should not allow it to recover any revenue lost through discounting by increasing other charges. If these two conditions are met, then discounts will be offered only when to do so would increase Aer Rianta's revenues and profits, thus promoting economic efficiency.

A hybrid tariff/revenue cap promotes efficient growth

Q11

We believe that Aer Rianta should have an incentive to increase passenger volumes, while ensuring that service quality is maintained. This points towards a tariff cap, rather than a revenue cap approach. The latter would not produce increased revenues from increased traffic volumes. However, a pure price cap would be over-generous. Air traffic is increasing rapidly and will continue to increase almost regardless of Aer Rianta's actions. However, Aer Rianta's costs will not increase in proportion. Consequently, a pure tariff cap would provide Aer Rianta with additional profits without any effort on the airport operator's part. This suggests that there should be a hybrid of a cap on individual tariffs and a total revenue cap, as outlined in 4.4.3A of the Consultation Paper. Revenue should increase with increasing volumes, but not on a one-for-one basis.

All activities located at airports should contribute towards shared costs

Scope of aeronautical charges

Q5 – Appendix A lists all of the items that should be regulated under the scope of aeronautical charges.

Regulation of aeronautical charges

Q6

The services listed above constitute essential facilities which cannot be avoided by airport users. Consequently, charges for their use should be regulated. Such regulation should ensure compliance with principles of EU and Irish competition law regarding access to essential facilities. We see no reason for regulation of other services such as commercial activities (e.g. car parking, duty free shops) as long as a single-till arrangement is in place. There are undoubtedly advantages to locating at the airport, space is limited and so commercial activities located there earn super-normal profits some of which Aer Rianta should capture for the benefit of all airport users.

Charging passengers directly

Q31

Charges should be paid by those using the services funded by the charges. This implies that passengers should pay directly for passenger-related airport services, perhaps through a charge levied by the airport operator after check-in. Similarly, passengers could pay directly for choosing to use specific services, such as trolleys.

Such an approach would also end the anomalous practice of travel agents charging commission on the full price of a ticket, including passed-through airport charges. This adds to the overall cost of air travel for passengers.

A single till matches airport revenues to airport costs

Q27, Q28

We support the single till, which is the most widely-accepted approach to dealing with the synergies between commercial and aeronautical activities in airports across the world.

Under the single till, profits arising from commercial activities at the airport contribute towards the costs of providing "aeronautical" services, broadly defined. This seems entirely appropriate, since if those aeronautical services were not provided, there is no reason to suppose that any economic profits would arise from commercial services provided at the airport. Commercial advantages arising from Dublin airport's location, for example, are not unique. There is no reason to suppose that offices, shops or restaurants would choose to locate there rather than at other locations near the capital, were it not for the existence of an airport served by airlines.

Commercial activities at Aer Rianta's airports are profitable because airlines serve those airports. Under a dual till system, aeronautical charges to airlines and their passengers would rise. Either Aer Rianta or the commercial operators (depending on whether commercial revenue was capped) would make higher profits, as a result of the facilities paid for by airlines and their passengers. We see no benefits to passengers or the economy more generally arising from such additional profits.

There is evidence that the single till promotes economic efficiency. Airlines, airport operators and commercial activities together provide a joint service. This joint service has a value, as signalled by the desire of passengers to pay for the joint package. It would be perfectly possible for the joint service to have a value even if customers were not prepared to pay the full costs of aeronautical services through airfares. A company owning all three aspects of the service – airline, airport and commercial activities together – would not regard this as a problem. It would regard "losses" on the airport and airline accounts as being outweighed by "profits" on the commercial account. These profits would not exist were it not for the aeronautical services. Similarly, commercial activities should contribute towards aeronautical costs when the three activities are separately owned.

Restricting the single till to activities at and around airports

The discussion above concerned commercial activities that are enhanced by their location at, or near, the three regulated airports. Aer Rianta is involved in other commercial activities that fall outside this definition – notably its hotels and international businesses. It would be inappropriate for the revenues from these activities, or Aer Rianta's costs of providing them, to be included within the single till. Too broad a definition of the single till could result in Aer Rianta cross-subsidising (or at least guaranteeing against risk) activities in competitive markets out of charges levied on Irish airport users, who have no freedom to choose other suppliers. The Commission should ensure that shared facilities within Aer Rianta – such as head office costs – are not disproportionately allocated to the airports business in Ireland. Activity-based costing may be helpful in allocating these costs.

Q30

Joint costs will vary from airport to airport and could be identified under the heading of specified activities e.g. electricity, water, car park passes, medical infrastructure etc. Allocation should be by cost divided by usage and should not be biased in favour of any one set of airport users.

Competition in provision of Airport Services

Q36,Q37

At present, there is no effective competition to Aer Rianta across a range of services that could be provided by others. If such competition were to appear, there would clearly be a case for removing some regulatory restrictions. We would expect Aer Rianta's own efficiency and service quality to improve dramatically if it were faced with a competitor: regulation is inevitably a second-best solution. Effective competition could therefore result in some activities being taken outside the price control, although the mere prospect of competitors entering at a future date should not. At present, there is no real competition and so price controls are essential.

Even if more providers appeared, however, we believe that the Commission should still ensure that there is open and non-discriminatory access for all airport users. The integrated nature of airport operations makes it essential that no airline is excluded from using any of the services available. We welcome competition in providing airport services but we would be concerned about the possible creation of smaller, unregulated monopolies at key bottlenecks.

Determining the cost base

Assessing expenditure requirements

Q13

There is a strong link between the question of how to assess investment requirements and that of how to set quality targets. We believe that the answer to both lies in more effective consultation with Aer Rianta's main customers.

Ultimately, airlines and other airport users are the beneficiaries of effective investments by Aer Rianta, and also pay the costs of any gold-plating. In the past, consultation has been ineffective. Aer Rianta has "consulted" its customers but proceeded with inefficient investment plans without regard to their views. Customers, and airlines in particular, should have more effective rights to prevent Aer Rianta taking decisions that do not provide value for money. Both in this review process, and during the course of the price control period, we – the customers – should have the right to scrutinise, require amendments to and, *in extremis*, reject Aer Rianta's specific investment proposals. Because Aer Rianta is a monopoly supplier of airport services, the regulator's backing is essential to such consultation.

We propose that the regulator provides support for setting up a forum in which the existing users of the airport can assess investment decisions. Members of the forum should have influence in proportion to their activities at the airports. This forum must have powers, backed by the regulator, to approve investment plans. Otherwise it would simply degenerate into the ineffective "consultation" carried out by Aer Rianta in the past.

Funding capital expenditure

Q14

We strongly oppose the idea of earmarking one of the charges for capital expenditure. The charges reflect different services. The same service could be provided or enhanced either by investment or operating expenditure. It is an important aspect of commercial freedom to allow the airport operator to choose between the two. Tying the charge for one service to the costs of using one method of providing all services is not cost-reflective and may introduce significant, arbitrary and inefficient distortions in relative charges and in Aer Rianta's decisions.

Q15

Charges should only reimburse existing assets. If assets are charged for before they are built, existing users are cross-subsidising future users, who in turn receive better service without paying the full costs of providing that service. Charging for assets only after they are built is standard practice in regulated utilities. This is particularly important in the air sector, since those using air services now cannot be assumed to be identical to future users. The experience of pre-funding of Terminal 5 at Heathrow illustrates the dangers of allowing revenues to anticipate future investments that may be delayed or judged unnecessary. BAA's customers may have missed out on price reductions of as much as 5% per year over five years, without as yet receiving any benefits in increased capacity. Furthermore, the justification for T5 prefunding – BAA's high costs of raising capital from the markets – is unlikely to apply to Aer Rianta as a state-owned enterprise.

The regulatory asset base

Definition of the regulatory asset base

Q16

Broadly speaking, the regulatory asset base (RAB) should only include the assets required to support the services defined in Question 5. As we noted in our discussion of the single till, Aer Rianta Group would obviously gain from including as much of its assets as possible in the regulatory base and the regulator should assess with care its submissions in this area. It would be inappropriate for airport charges (which are unavoidable levies on users of an essential facility) to cross-subsidise competitive activities such as the hotel business or international activities. The regulator should seek to exclude an appropriate proportion of any assets shared between these activities (such as head office costs) from the RAB.

Charges for capital costs

Q17, Q18, Q19, Q20, Q21

Charges to customers should include an element to cover depreciation charges and a return equal to Aer Rianta's cost of capital, on an asset base calculated using historical costs, from which inefficiently-incurred costs have been excluded.

Valuation of the asset base

In principle, Aer Rianta's regulatory asset base (RAB) could be valued using historical costs (adjusted for inflation and depreciation) or at replacement cost (again, with a depreciation factor applied). We favour the former approach, since it is more transparent and leads to more stable charges.

Regulators often draw a distinction between how they value existing assets at the time a new regulatory regime is set up and how they value additions to the RAB. For example, the existing RAB could be valued on a depreciated replacement cost basis but if this approach is applied in future, the value of the RAB (and charges) will be unstable. It is difficult to explain to customers that charges should increase merely because unit investment costs have increased, even though much of the asset base will have been constructed at cheaper rates. Stability of charges requires that the RAB is uprated only for inflation and depreciation calculated on the historical cost of the assets, not on a replacement cost basis. This is particularly important since Aer Rianta's unit investment costs are to a large extent under its own control.

This leaves the question of whether the existing asset base should be revalued using replacement cost. We suspect that in Aer Rianta's case, there will be little difference between the two approaches. Investment levels have been high over the last few years and Aer Rianta's asset base is therefore relatively young. We would be surprised if a replacement cost approach were to yield a significantly different answer from simply using historical costs updated for inflation and depreciation. We therefore see no reason for using replacement costs to revalue the asset base. If Aer Rianta were to argue for an upward revision to its asset base on such grounds, the Commission should critically examine the justification for assuming that unit investment costs have risen.

Neither of these accounting approaches, of course, has any bearing on the question of whether Aer Rianta's asset base is *efficient*. Whatever the accounting treatment of the asset base, customers should not be expected to pay for investments that were inefficient, either because they were unnecessary or because they were carried out at excessive cost. The Commission should carry out an efficiency analysis of all Aer Rianta's costs and disallow any costs that were inefficiently incurred, whether they are in the capital or operating cost accounts. We return to this issue later.

Appropriate rate of return

As the Consultation Paper suggests, the regulator should allow a rate of return equal, over the medium term, to the company's cost of capital. Within a CPI-X framework, of course, this can only represent an expected return. X should be set on the basis of a reasonable expectation of efficiency gains, so that Aer Rianta will only earn returns above the allowed rate if it achieves exceptional efficiency gains. We believe that it is entirely appropriate that the airport operator should make increased returns if its cost and service quality performance justifies it. However, there is no reason to set the initial expectation for Aer Rianta's allowed rate of return at anything other than its cost of capital.

Estimating this cost of capital cannot be an exact science, since no share price data are available to allow an application of the CAPM approach. The nearest comparator with traded shares is BAA, which was given an expected rate of return of 7.5% (pre-tax, real) at the last review in 1996. However, while BAA's allowed cost of capital can be considered as a *starting point*, the Commission must make adjustments to reflect Aer Rianta's different circumstances. In particular, account must be taken of the following points:

p The lower "risk free rate" that companies operating in Ireland need to obtain, compared to those operating in the UK, because of Ireland's adoption of the Euro. We note that Eurozone short-term bond yields are about 50 basis points below those for UK government.

p The general reduction in UK regulators' estimates of the cost of capital since BAA's cost of capital was last calculated. For example, allowed rates for utilities (electricity, water) have fallen from 7% in the mid-1990s to 5.5 - 6.5% for the 2000-2005 period. Comparing Ofwat's determination in 1999 with the last review of BAA, for example, the risk-free rate and the equity premium were each estimated at 1% lower.

p Most significantly of all, Aer Rianta as a monopoly and State-owned utility has a low or effectively zero likelihood of default. It should be possible for the corporation to fund investments solely through borrowing without raising the cost of debt much above the government's own cost of debt. At the very least, this factor should result in a considerable reduction in the allowed cost of capital (perhaps 2%) compared to BAA, even after taking account of the two factors above. At the limit, it does not seem unreasonable to allow a cost of capital at, or a little above, the cost of government debt, currently about 4.5% nominal.

This suggests that the cost of capital for Aer Rianta should be in the range of 3-4%, to reflect the cost of government debt plus a small premium.

Assessment of efficiency

Customers should not be required to fund inefficiency

Q22, Q23, Q24, Q29, Q33, Q34, Q35

Customers should not be required to pay for inefficiently incurred costs, whether ongoing or historical. This review provides a valuable opportunity to assess Aer Rianta's efficiency and base charges only on the efficient cost levels determined by such an assessment. We strongly urge the Commission rigorously to quantify Aer Rianta's inefficiency, since there is overwhelming evidence that significant inefficiency exists.

We recommend that the Commission puts the burden of proof onto Aer Rianta. There should be no presumption that its activities are efficient unless Aer Rianta can prove they are. The Commission should insist on rigorous proof of efficiency before allowing costs to be passed to customers, either in:

· current operating costs;

· future investment plans; or

· costs of the existing asset base.

Inefficiencies in operating costs should not be passed through to customers and should be disallowed from the start of the price control period. It is economically inefficient to require customers to pay more than the costs that an efficient operator would require to provide a service and we see no reason to allow Aer Rianta to recover any inefficient costs at any time.

If airport users, acting through the forum discussed above, are not prepared to fund elements of future investment plans, then the Commission should regard that as inefficient investment and exclude it from the cost base for the present price control.

Regulators are sometimes reluctant to disallow inefficient past investment expenditure, thereby "writing off" assets. However, this reluctance leads to incentives for regulated firms inefficiently to invest to "protect" their cost base from regulatory scrutiny. Since Aer Rianta already appears to be investing inefficiently, the regulator must be prepared to conduct a thorough efficiency analysis of Aer Rianta's existing asset base as well as its ongoing costs. Since the airport operator is still in state ownership, such an exercise would not have any adverse effects on investor confidence. Indeed, it would send a strong signal that charges will consistently be set only to reimburse efficient costs, whether those costs are incurred on the capital or operating accounts. If Aer Rianta were to be privatised such assets would effectively be written off, since investors would be unlikely to pay for them at book value if they obviously failed the value for money test. This review is therefore an ideal opportunity to set up a consistent regulatory regime that provides incentives for making an efficient choice between operating expenditure and investment.

Assessing inefficiency

Evidence of inefficiency

There are many examples of inefficient investment on the part of Aer Rianta. In virtually all cases the inefficiency was as a direct result of the lack of consultation with the airport users. Some examples illustrate this point forcibly:

1. The cost, design, development and introduction into service of the six bay extension at Dublin Airport.

2. The cost, design and development of the new baggage hall and arrivals area at Dublin Airport.

3. The cost, design and development of Pier C at Dublin Airport.

4. The introduction of CUTE.

5. The cost, design, size and development of the new terminal building at Shannon Airport.

6. The cost, design and development of the Cargo Terminal at Cork Airport.

The recent snow at Dublin, which caused little or no disruption to road traffic in the city, caused the closure of the airport and the cancellation of hundreds of flights. Operations at the airport did not return to normal for over two days after the snow had stopped.

The benchmarking process

It is essential that any benchmarking process covers total costs – not simply operating costs – and takes account of quality issues.

Benchmark total costs, using consistent measures of capital costs

Airports, like any other commercial organisation, can substitute between operating and capital costs, either by changing accounting definitions or by physical actions. For example, an airport operator could use more or less automated information processes and would probably regard IT expenditure as "capital" while staff costs are "operating" expenditure. It would be inappropriate to decide that an airport was efficient on operating expenditure if it had invested heavily in labour-saving technology: such an airport *should* have lower operating costs than its peers. Benchmarking therefore needs to cover total annual costs, including an annualised measure of capital costs. If costs data is unavailable, benchmarking charges can have much the same effect.

It is important to use a consistent definition of capital costs. We noted above that Aer Rianta's cost of capital is likely to be significantly lower than that of BAA. The same annulisation calculation must be used both for Aer Rianta's capital costs and those of BAA to produce a valid benchmark. Aer Rianta's management is not more efficient than that of BAA simply because state ownership allows it to borrow more cheaply.

Including quality

It is possible to incorporate quality measurements directly in an analysis of airport costs. If quality is not included, then the benchmark would be set by an airport that has sacrificed quality for the sake of cost savings. This would not be appropriate given that the Commission has, rightly, highlighted quality as an issue in this review. Similarly, Aer Rianta should not be judged to be efficient if it has similar costs to an airport, which provides a significantly better service to its customers.

Interpreting the results

The regulator will need to use his judgement in assessing the results of benchmarking. Even the most sophisticated benchmarking techniques will not produce an unambiguous statement of Aer Rianta's efficiency, given the very different circumstances in which airports operate. Results should not be rejected simply because they are unclear and require interpretation. Even if the information produced by the exercise is of mixed quality, it is still valuable and can help to inform the regulator's judgement. If too high a threshold of evidence of inefficiency is required before the regulator will act, then there is a danger of reversing the burden of proof. It is up to Aer Rianta to justify its charges by proving that it is efficient.

We recognise that the benchmarking exercise will not be easy but we believe that it is essential to provide an external assessment of Aer Rianta's activities. We would be happy to assist in designing and interpreting any benchmarking that the Commission decides to carry out. We could, for example, advise on differences between airports that may not be apparent from the raw figures. More generally, we would appreciate a period of consultation on any benchmarking exercise, before the Commission decides how to use the results in setting draft price controls.

Maximising airports' contribution to the local economy

Q25, Q26

A full cost-benefit analysis of how airport activities contribute to the region in which they are located (including that of Dublin) is unlikely to be possible within the time available for this review. However, one thing is clear. Airports will only make a useful contribution if airlines are prepared to serve them and passengers are prepared to fly through them. Airports can therefore best contribute to the regional economy by being run efficiently and having low charges that reflect only those efficient costs. If this review promotes efficient operation and charging for regional airports, it will have made a significant contribution to regional development.

Service quality: the need for enforceable agreements

Q32, Q38, Q39, Q40

We introduced earlier the principle of direct consultation between Aer Rianta and its principal customers in the context of investment appraisal. We believe that direct agreements between the airport operator and airlines would also be the most appropriate way to ensure service quality is maintained or, where required, enhanced.

The alternative, of directly incorporating service standards in the price control formula, has proved difficult to implement in regulated industries in the UK. It is easy to design a formula to incentivise quality but very hard to get it right. The consequences of getting it wrong could be gold-plating, if the formula is too generous, or insufficient attention being paid to quality if the penalties are too light. Whatever the overall incentive for performance, direct regulatory control of quality is likely to result in game-playing i.e. actions directed at improving the quality score, rather than broadly-defined quality itself.

Service quality regulation should not, therefore, be in the price control until agreements between airlines and the airport operator ("Service Level Agreements", or SLAs) have been tried as an alternative. SLAs have been introduced since the last price control review of BAA's airports in the UK and our impression (as a participant in one agreement, and from more general observation) is that they have worked well. Agreements concluded directly with airports will provide a more focused approach to solving problems of quality than the informal and ineffective consultation processes have achieved to date. Furthermore, compensation clauses for failure to perform would provide Aer Rianta with an incentive to improve quality where its customers value such improvements.

However, we do believe that the regulator needs to be closely involved in this issue, as was the CAA in recommending SLA's during the last review in Britain. Aer Rianta has a monopoly of airport services and will not pay due regard to its customers' views without regulatory pressure. The Commission should require Aer Rianta to draw up SLA's with the main airlines serving the three controlled airports. This process should begin during the current price control review, while Aer Rianta is under threat of an adverse price control decision.

This timetable would allow time to prepare a regulatory alternative, if Aer Rianta is not prepared to agree to an SLA with effective compensation clauses for under-performance. We would regard a regulatory solution to the issue of quality maintenance as very much second best. However, it should be available as a fallback position if necessary, since otherwise service quality would be put at risk.

Cross-reference

Commission question number	Page
Q1	5
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Q4	*General issue, applicable to many responses*
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Q37	12
Q38	20
Q39	20
Q40	20
Q41	*General issue, applicable to many responses*

APPENDIX A

Scope of Aeronautical charges

Runway provision and maintenance

Taxiway provision and maintenance

Airfield lighting

Bird scaring

Airfield supervision

Fire service (airfield and terminals)

Snow clearance – runway and ramp

Airside and perimeter security, including access control and patrolling

Apron control and allocation of aircraft stands

Apron and aircraft parking area provision and maintenance

Guidance systems and marshalling

Loading bridges

Fixed Electrical Ground Power

Piers and gaterooms

Check-in concourses including check-in desks

Toilets and nursing mothers' rooms

Airside lounges

Customs and Immigration service

Baggage systems, including baggage sortation, baggage reclaim and transfer infrastructure

Arrivals concourses and meeting areas

Trolley service

Signing

Information desks and staffing

Flight information and PA systems

Scheduling Committee support

Lost property service

Airside access roads and forecourts, including lighting, traffic signals, signage and monitoring

Staff search (except for issuing of ID passes to non Aer Rianta staff)

Passengers and hand baggage search

Policing and general security

Cleaning, heating, lighting and air conditioning of public areas

Lifts, escalators and passenger conveyors

Noise insulation/soundproofing

Refuse disposal

Foul and surface water drainage, other than to leased properties

Facilities for the disabled and lift on lift off

INS

Oil spillage

Pax Profile security

CUTE

Hot and Cold water

Light, Heat and Power

Airline Staff Car Parks

Fuel levy and supply

Customs facilitation charges

Full hold baggage screening

Common infrastructural requirements

Accommodation for airline offices and for the handling of passengers and cargo

Cargo throughput fees

Space for parking and longterm storage of aircraft and equipment including ground handling equipment

Hangar, workshop, stores, garage and other technical accommodation

Land and buildings leased to aircraft operators for various purposes

Communication facilities

Noise monitoring systems, noise suppressing equipment and noise barriers

Concession fees charged on services provided to airlines

Mr William Prasifa

Commissioner for Aviation Regulation 8862334

36 Upper Mount Street

Dublin 2. 8866610

27 March 2001

Dear Mr Prasifka

I enclose the response of Aer Lingus to the Consultation Paper on Economic Regulation of Airport Charges (CP2/2001).

Please do not hesitate to contact me further in relation to the submission enclosed.

John O'Donovan

Company Secretary

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[1] However, two questions are so broadly-defined that they are covered throughout this document as a whole. These are questions 4, on the relevant experience from outside Ireland that should inform the regulator's decision and 41 on national and international obligations.

[2] See, for example, Doganis R. (1992), *The Airport Business*, Routledge, London and Beesley M. (1998), "Airport Regulation", *Regulating Utilities: A New Era*, IEA. We also note that the MMC, over the course of three reviews of BAA, has continually reduced its emphasis on peak pricing (see, for example, Starkie, D. (1999), "A New Deal for Airports", *IEA Regulation Lectures*.). This is likely to reflect a move from a theoretical standpoint to a more practical awareness of the economics of the air transport business.