

Dr. Adrian Corcoran
Director of Economic Regulation
Commission for Aviation Regulation
Earlsfort Terrace
Dublin 2.

23rd November 2021

Dear Adrian,

Aer Lingus is grateful for the opportunity to respond to the Commission on its draft decision in relation to 2022. Our response focuses on both high level (for example the Commission's interpretation of its duties) and operational level (for example the service quality metrics).

Capital Clawback

With respect to the Second Interim Review we are particularly disappointed with the Commission's decision on capital clawback. Notwithstanding the decision of the Appeals Panel, we renew our objection to the Commission's decision in this regard.

The key issue here is that the airlines and their passengers have paid daa for a service (ie delivering a series of capital projects) which (ostensibly due to Covid), the airport has not delivered. The Commission rightly notes that the purpose of economic regulation is to set an incentive structure that forces the regulated business to behave *as if* it was a competitive business. For competitive businesses, like airlines, if you take a customer's money and then don't deliver the service, you give the money back. It seems odd then that the Commission does not wish to impose this commercial discipline on daa.

Indeed, not doing so sends an unhelpful and perverse signal to daa – that the Commission will prioritise the financial health of daa's shareholders over sending proper market signals that force daa to behave as if they were a competitive business. We are concerned about the implications of this decision for future control periods.

Risk, Reward and Covid

We note that the Commission states that the total value of its Covid interventions (i.e. the transfer of value from our passengers to daa's shareholders) will be in the order of €200-220m. We also note that the Commission states that thanks to its intervention and that of the Government, daa's losses for the latest year where accounts are available was limited to €2m. By way of comparison, Aer Lingus' EBITDA over the same period was a loss of €405m.

We also note that included in daa's minor loss of only €2m, was €87m in restructuring costs, which included some very generous severance packages. Had the severance schemes and restructuring been handled more efficiently (for example if daa's severance scheme had mirrored the more efficient terms of Aer Lingus' over the same period), the action of the Commission combined with the Government's subsidies on daa's EBITDA would have been to ensure a small profit. This is remarkable given the impact of Covid on the industry and the losses being made by aviation businesses not protected by a regulator. It is unambiguously clear to investors as a result, that the Commission will always act to insulate daa from risk, and that it is to all intents and purposes a risk-free business. This treatment in turn demands a lower WACC.

Looking ahead to the more fundamental review of pricing that the Commission is initiating, it seems clear to us that the position on risk is clear. When dealing with the impact of Covid through its two Interim Reviews, the Commission had a choice: treat daa like a competitive business and force its equity holders to support any losses; or use the regulatory regime to effectively insulate daa from any downside risk from Covid.

Given that the Commission has chosen to insulate daa from Covid risk, it must reject any claim from daa that Covid has somehow made it a riskier business. In fact, if anything, daa has become even less risky from an investor's perspective, as it is clear that its regulator will always seek to insulate it from any unanticipated downside risk. Consequently, it is our view that any review of risk must conclude that daa is as or less risky than before and so the elements in the WACC that deal with these issues (the betas) must fall.

In short, daa and the Commission cannot have it both ways – either the capital clawback must be allowed and overall risk reviewed, or the capital clawback should be suspended and it must be acknowledged that the regulatory regime acts to insulate daa from risk, and thus makes it less risky. Anything else is a logical impossibility.

Government route incentive and recovery funding

We note that the Government has made a supplementary package of €90m *'available to the [aviation] sector, which will enable our State Airports to target funding, by way of route incentives and rebates, precisely where it will have the best impact throughout the year and 2022.'*¹

We also note the Commission's intent to work with the Department for Transport and daa to facilitate this through the regulatory model. It is also essential that the airlines are involved in these discussions.

It is clear that the DoT's intention is not to provide daa with an additional €90m of subsidy, but rather that the money should be used on route incentives and rebates for the benefit of the airlines. We are concerned that without appropriate action from the Commission, the operation of the automatic true up process in the regulatory framework may allow daa to claim back the money and hence effectively negate and frustrate Government policy. Consequently, we believe that the Commission needs to make it clear in this decision that it will make whatever adjustments in future decisions to the automatic true-up mechanisms that are necessary to prevent such a situation arising.

Timing of a more fundamental review

We note the Commission's intention to initiate a more fundamental review of the building blocks to be conducted over 2022. Whilst in principle we support the Commission's decision to undertake a fundamental review of the building blocks, we restate our objection to the timing. We believe that the future path of Covid, and the recovery of the economy and passenger volumes is still too uncertain (and will remain so in 2022), and consequently that the Commission should defer its more fundamental review until 2023.

We regard the Commission's decision to undertake a full review of the building blocks. In 2022 as ambitious. Should the Commission not wish to wait until the data is more settled and the position with respect to Covid and passenger volumes clearer, then it will be necessary for the Commission to ensure its review contains sufficiently robust scenarios to cover all reasonable outcomes.

¹ DN – insert reference to DoT text

As noted above, given the unprecedented level of support that the regulator has already afforded the airport it would be inappropriate for the regulator to impose further costs on airport users through an arbitrary financeability 'lookback' assessment for 2020 and 2021 in the course of the full review.

Service Quality Metrics

Aer Lingus supports the Commission's decision to reintroduce some service quality metrics. However, we find the Commission's decisions on the rebates associated with these metrics to be confused and we are unable to support them.

We do not understand the Commission's decision on security queue targets. We do not accept that the task has become more challenging (except for daa's inability to staff the function correctly which is an issue for them and does not require regulatory accommodation). In summary, the airlines are paying for a service standard so that they can plan their businesses, and the rebate and queue metric is there to ensure it is delivered. There seems to be little sense in recognising that the metric should be reintroduced whilst halving the incentive to comply with it.

The same argument applies in the case of passengers requiring additional assistance.

In terms of the metrics around Baggage Handling Belt and IT systems and the availability of airport assets, the decision is even harder to understand and support. Essentially the Commission's argument is that because the presence of the rebate has meant that the service level has not been breached, it can remove the rebate. A natural reaction would be for daa to remove resources from meeting these standards to focus on meeting ones where rebates apply. The Commission's proposals with respect to these metrics fail to give significant recognition to the presence of rebates as a deterrent.

Finally, we note that the Commission intends to combine the 'finding your way around' and 'walking distance' measures into a single measure. Whilst we do not necessarily disagree, we would welcome further information from the Commission on what issues it considered in coming to this position in general, and its assessment of how likely the new measure would be to be breached as opposed to the two individual measures in particular.

In short, it is our view that the Commission has made changes to the rebate scheme solely with the purpose of lowering daa's risk level by reducing the level of revenue at risk. This is consistent with the actions of the Commission around capital clawback, which together seek to insulate daa from the impact of cCvid relative to normal commercial businesses, and which make daa less risky going forward.

Given the Commission's extensive efforts to de-risk daa, we expect that any future regulatory settlement will have a much lower WACC and lower scope for regulatory outperformance.

Yours sincerely,



Steven Ronald
Director of Schedules Planning and Alliances