DAA Response to CAR's consultation document *Future Investments and the Regulatory Till*, Commission Paper 1/2012, 26 April 2012

1. Introduction

DAA welcomes CAR's consultation document *Future Investments and the Regulatory Till*, Commission Paper 1/2012 (CP1/2012). The document represents a positive contribution in formally recognising the impediments to commercial investment within the regulatory till and in exploring how the regulatory system should address instances where users disagree with proposed new commercial investments at Dublin Airport. The strengths of the contribution include (i) the recognition that stakeholders have differing appetites for risk and (ii) the emphasis on commercial incentives and the importance of getting incentive structures right in order to promote value-generating commercial investment. These starting points indicate a requirement for clarity, efficiency and symmetry in the treatment of risk and associated rewards.

While welcoming CAR's contribution, DAA would also have a number of reservations. The first is that the scope of the proposals is narrow. DAA notes CAR's conclusion that it does not intend any fundamental shift in the current approach to the regulatory till in 2014, nor to revisit the issues of single till versus dual till in the current consultation process. CAR's focus in CP1/2012 is entirely centred on possible future exclusions from the till, as is deliberately reflected in the title of the document. DAA would not agree that the general configuration of the till should be closed off at this stage for once and for all, and we re-iterate in summary our view with regard to the relative merits of single-till versus dual-till approaches. However, in the main, our response addresses CAR's proposals within their own scope, which reflects our wish to engage in the process in a pragmatic and constructive manner.

Our second reservation is that CAR's specific proposals with regard to the exclusion of future commercial investments are limited in certain respects, in particular with regard to the conditions envisaged around 'agreement' to businesses exiting the till and the treatment of cost separation. If, ultimately, the mechanisms for till exclusion remain limited, it is possible that only very few investments/businesses would ever 'qualify'. This would be a lost opportunity, and the regulatory system would continue to be hampered by disagreement and impasse with regard to many commercial investments. In the response below, DAA builds on the principles set out by CAR in CP1/2012, but proposes specific and detailed process recommendations for dealing with the kind of disagreement that can readily be anticipated. Commercial investments come in different shapes and sizes, from new business without any link to the core function at one end of the scale to major investment in existing till businesses at the other. DAA's process proposals seek to deal with different investments by type, because the issues around risk, return and impact on airport charges vary considerably depending on the investment type.

DAA agrees that it would be useful to have clarity around future treatment of commercial investment in advance of the substantive work on the next determination in 2014. To this end, as well as putting forward process suggestions, DAA intends to put forward for consultation 'candidate investments', as envisaged by CAR in CP1/2012. In our view, an appropriate timeline for such consultations would be late-2012/early-2013.

This document is structured as follows:

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2. Comment on CAR's overall approach to the regulatory till

Explicit in the Commission's re-articulation of its commitment to an essentially single till approach is the idea that commercial revenues earned by DAA (which have a close nexus to the core aeronautical function) should be used to subsidise airport charges because (i) this would be the expected outcome in a fully competitive market and (ii) it is the role of the regulator to seek to replicate competitive market outcomes. DAA would comment as follows:

- With regard to (i) above, this is an overly stylised view of the outcome in a competitive market, which will depend on the nature of demand and on the nature of competition itself.[1] DAA would not agree that this view should be regarded in the regulatory process as an immutable fact, which it is not.
- Economists are generally rightly sceptical about cross-subsidies because they distort price signalling and lead to inefficiencies in the use of resources. Even if the principle of cross-subsidisation were accepted in this case, the chances of the regulatory process setting the subsidy at the right economic level must be very low.
- Accurate price signalling is particularly important in a dynamic context, i.e. in order to understand present and future demand and plan and execute investment in new capacity accordingly.
- DAA believes that a dual-till approach is ultimately a better mechanism to ensure economically efficient provision of airport facilities and services at Dublin in the medium-term. However, DAA accepts that CAR does not intend to deviate fundamentally from the current till approach, and has engaged in this consultation from that basis.

In DAA's previous submission to CAR on the regulatory till (23 March 2011, responding to CP4/2010), we explored in detail some of the drawbacks of the single till approach. It is not necessary to repeat these arguments in full in this submission, but it is useful for the current purpose to emphasise a number of points:

- The current regulatory practice is characterised by airlines supporting the idea that airport charges should be subsidised from commercial revenues, but being unwilling to accept within the till the capital expenditure required to maintain and develop the commercial revenues in question. This may be contrary to the airlines' own long-term interests (i.e. maintaining the subsidy), but the behaviour is nevertheless observed.

[1] See, for example, Zimmerman, P and Carson, J (2010), 'Competition and cost pass-through in differentiated oligopolies'. Available from http://mpra.ub.uni-muenchen.de/25931/

- The incentive structure faced by DAA is such that any improvements in commercial revenue within the till will, over time, be entirely subsumed into the subsidisation of airport charges. Regulators seek to replicate competitive market outcomes because such outcomes are deemed to be efficient. The mechanism driving competitive market outcomes is individuals and companies seeking to maximise their own welfare given the set of incentives they face. An incentive structure in which a company is impeded from commercial investment and in which it cannot retain additional revenues is not optimal.
- *Regulating Better*[2] requires that regulation be necessary and proportionate (i.e. the minimum required). The principles of economic regulation are founded in the objective of replicating competitive market outcomes in circumstances where market power occurs. Where market power does not occur, intervention through economic regulation may be distortionary and inefficient. Generally speaking, DAA does not have market power in its non-aeronautical activities. Therefore, it would be more efficient for those activities not to be regulated.
- The only rationale for a single till approach – as per the CAR's position in CP1/2012 – is to maintain a subsidy of airport charges from commercial revenues.
- Reviewing international practice with regard to the economic regulation of airports, it is clear that different approaches are taken (single till, dual till, hybrid till) and that practice can change over time. Recent years have seen a clear shift in some jurisdictions from pure single-till approaches towards dual till and hybrid till variations.

Leaving aside for present purposes the broader issues of the economic appropriateness of subsiding airport charges from commercial revenues, DAA welcomes CP1/2012 as a positive step towards addressing some of the immediate inefficiencies that are apparent in the current regulatory practice with regard to commercial investments. CAR approaches this matter from a number of angles in CP1/2012, for example as follows: '*In instances where the DAA wants to proceed with a commercial investment that users oppose, we are willing to adapt the regulatory till such that the DAA can make the investment knowing that it rather than users will bear all the risks of the venture. Future determinations will have no regard to the costs or revenues associated with the investment, so it will have no implications for price-cap calculations for airport charges.'* DAA supports this principle. The remainder of this response document is essentially devoted to examining how the proposal might work in practice (DAA has specific recommendations in this regard) and to considering the associated issues, many of which are raised by CAR in CP1/2012. In addressing this subject, it is useful firstly to look at different investment types in turn.

3. New business with weak/no linkage to the core aeronautical function

It is an established principle of CAR's regulation that where a business activity has insufficient nexus[3] to the regulated activities it is excluded from the till. This has applied in regard to the Group's previous ownership of the Great Southern Hotels, Aer Rianta International and also certain DAA property joint ventures. One of CAR's stated objectives in CP1/2012 is to create more certainty about the future treatment (at the following determination) of investments undertaken in the course of the 5-year pricing period. CAR writes as follows: '*The proposals . . . seek to develop a more structured framework for considering future commercial investments when making determinations. We hope that this will benefit all stakeholders, by providing . . . a better understanding of how future*

[2] 'Regulating Better', Department of the Taoiseach (2004); Government White Paper, which sets out principles for better regulation; see www.taoiseach.gov.ie

[3] For example, CAR states the following in CP1/2012: '*More generally, by excluding investments that we do not think have a sufficient nexus to the airport (e.g. investments by DAA Group at other airports), we have implicitly adopted an approach to defining the regulatory till that is more pragmatic than the most dogmatic approach to single-till regulation might require.'*

determinations might treat commercial investments, allowing parties to plan accordingly.' In keeping with this, DAA proposes that CAR establish a set of clear criteria against which new businesses can be adjudicated to be outside the till by virtue of 'insufficient nexus'. DAA proposes the following criteria:

- Where the business in question is not essential to the provision of airport services at Dublin Airport;
- Where the business in question is demonstrably subject to market competition;
- Where the business does not compete with an existing business within the till (see discussion below);
- Where the business would not materially be affected by a small but significant and non-transitory change in the volume of passengers through Dublin Airport[4].

As an example of a type of business that would fall into this category, DAA is currently establishing an international consultancy business. Such a business would be adjudicated to be automatically excluded from the till. An important point to note about these criteria is that the location of the business is not a relevant factor per se. For instance, a new business could be established on land currently at the campus, which would nevertheless be outside the till by virtue of meeting the above criteria. Since such an initiative would have no impact on airport charges, the issue of an exit value from the RAB would not arise (see discussion below).[5]

4. New business with linkage to the core aeronautical function

For a new business that would fall within the till by reference to nexus, DAA proposes the following processes, distinguishing between businesses which require incremental capital investment and those which do not.

4.1 New business requiring capital investment

For small miscellaneous investments (commercial revenue projects), DAA proposes the establishment of a **Commercial Innovation Allowance[6]**. At present, there is no regulatory allowance to cover instances in which DAA invests unilaterally in a new commercial opportunity. By definition the investment is speculative, in the sense that performance cannot be guaranteed in advance. The process of developing such opportunities is often iterative and involves commercially sensitive information and discussions. Formal consultation with users would generally not be efficient or workable in these cases. (In some instances, DAA may even be in competition with airlines for the provision of services.) Examples of such businesses include Airport Genie and Plane Water, recently established by DAA. At the time of the next determination, there will be a good period of information on the trading performance of both businesses and future trading prospects will be readily assessable. In a scenario where the businesses appear successful, it is likely they would readily be admitted to the till (indeed, it might be insisted upon that they belong within the till). In a

[4] This is a variation of the EU Commission's SSNIP test which is used in competition law. Where a business is not affected by changes in passenger volumes, this is a clear indicator of an absence of nexus. Importantly, following CAR's logic, an airport operator in a fully competitive market would not choose to subsidise airport charges with commercial revenue from such a business.

[5] CP1/2012 makes reference to the fact that future aeronautical requirements might require excluded land to be brought back into the till (and valued appropriately and fairly at that time). The point is also made that consultation on investment plans for activities excluded from the till would not be required, except where the plans had implications for aeronautical services. DAA recognises the validity of these provisos, where the requirements/impacts are material.

[6] There are precedents for this type of approach in other regulated industries, for example the Network Rail Discretionary Fund introduced in the UK. That is not to say that this example or any other is directly transferable to airport regulation and the particular characteristics of the single till, but rather to emphasise the point that new regulatory tools can be created for specific circumstances.

scenario where the businesses appear marginal or unsuccessful, it is likely that there would be resistance to admitting them to the till. There is a clear asymmetry here, in that DAA carries the risk of negative outcomes, while the till would benefit from positive outcomes. Innovation is an important aspect of commercial revenue development, and is by its nature subject to risk. This should be allowed for within the regulatory system. The following determination would be an appropriate point for decision on whether the till wished to accept further investment in such projects. If further investment within the till was opposed, it would be open to DAA to continue the business outside the till (see discussion below with regard to exit values, but these would be small and relatively uncontentious in the case of the type of ventures we are discussing here).

As stated, the above refers to small miscellaneous investments. For new businesses requiring larger discrete investments, DAA would propose the following:

- DAA would forward the investment proposal for consultation with the users.
- The consultation document would set out the financial case, including the capital investment profile, and the expected revenue and costs. The time horizon would be appropriate to the nature and level of the capital expenditure involved.
- In the event that the users supported the investment, the investment would proceed within the till. In the event that the users did not support the investment, DAA would have the option of proceeding with the business outside the till.
- In the consultation document, DAA would indicate how the revenues and costs would be ring-fenced from the till in the event of proceeding outside the till. Typically, this would entail the business being treated at a commercial arm's length distance by DAA where the business was purchasing services from DAA.
- DAA would have flexibility with regard to the timing of the consultation. In certain cases, it may be that DAA would proceed to consultation after the investment had been committed to, for example in the case of a property transaction, the proposed terms of which could not be revealed in advance for reasons of commercial sensitivity. In that case, DAA would bear the risk of the investment not being accepted into the till.

4.2 What constitutes agreement on the part of users?

As a general point, DAA would not accept that user agreement should be a necessary condition of regulatory approval of investment at Dublin Airport. There are a number of reasons for this, including that it is unworkable in practice because airlines have demonstrated a tendency to oppose most investments. Airlines have commercial concerns that do not invariably coincide with national transport policy objectives as reflected in the different legal mandates of DAA and CAR. On the contrary, airlines have clear incentives to game the regulatory system, an issue which DAA has raised in the past and which we will revisit. However, DAA does accept, as a matter of pragmatism, CAR's principle that the **process for till exclusion** will involve users expressing their agreement or disagreement with particular investment proposals, and this in turn prompts consideration as to what will be taken to constitute agreement. A number of points arise:

- It is generally unrealistic to expect that users will speak unanimously on any given point. The proposed regulatory process should be designed to function in scenarios in which users speak with individual and heterogeneous voices.
- Although the airlines have on occasion contributed collectively to the regulatory process, e.g. through DACC, this has been the exception rather than the rule. Even where the airlines did speak collectively through DACC, individual airlines nevertheless made their own submissions in some cases. DAA would propose that it would be appropriate to accept a collective position as articulated by a collective body only after having regard to the constitution, operating practices and membership of the body in order to ensure that it was a genuinely representative institution.

- DAA would propose – as is the current practice – that users would be invited to participate individually in the consultation process. Following the conclusion of the consultation process, and bearing in mind in particular the written submissions of the users, DAA would take a view as to whether the users were broadly in favour of including the investment within the till. The consultation response, including airline involvement, would be fully reported. In the event that the responses could not be characterised collectively as being broadly in support, DAA would assume no support. DAA's conclusion in this regard might be a matter for CAR to review at the next determination.
- A key aspect of DAA's proposal is that where the users were not broadly in agreement with including the investment within the till, DAA would automatically have the option of proceeding with the investment outside the till, i.e. there would be no requirement that users separately agree that the investment be allowed outside the till. To impose this latter requirement would be to set the bar too high and would virtually guarantee the kind of paralysis which CP1/2012 seeks to avoid. The objective is to remove barriers to value-generating investment. If the users do not support the investment within the till (we are talking about a new business here, not an activity already within the till), this should be sufficient to allow DAA to proceed outside the till. **Establishing this principle would deliver the objective of reducing uncertainty for all parties in the period between determinations.**
- A risk to DAA in this proposed approach is that it would assume 'broad support' and that CAR would later determine – on the basis of examining the record of the consultation process – that there was not in fact sufficient support for DAA to have made this conclusion. In that case, the consequence would be that CAR would place the investment outside the till. However, it would be the views of the airlines as expressed at the time of the consultation that would be relevant, rather than views expressed at a later time. This would be necessary to counteract a situation wherein an airline was supportive of the proposal at the time of the specific consultation, but then argued against it during the following determination process.

*4.3 New business **not** requiring capital investment*

Suppose for the sake of argument that there exist business opportunities which do not necessarily require (significant) incremental capital investment on the part of DAA.[7] DAA would have to invest management time and current expenditure in identifying and developing such opportunities. In the current regulatory environment, the additional revenue such from such opportunities is ultimately absorbed by the till (reducing airport charges). This is a weaker incentive structure than one in which DAA was able to retain some of the additional revenue in question in the medium term.[8] There is also an asymmetry here that needs to be addressed. A new business that did involve capital investment would have a route out of the till, whereas there would be no apparent exit mechanism for the same business in the case where the financial structure of the proposition did not involve capital expenditure. Arguably, this could create an incentive for DAA to favour new business propositions requiring capital investment over those not requiring capital investment.

[7] For the purpose of clarity in distinguishing between different types of business opportunity, we refer to new businesses requiring capital investment on the part of DAA and those not requiring capital investment on the part of DAA. In reality, there may be some small element of capital investment by DAA required in a latter case, but not to the extent of its being appreciable for the purposes of the till discussion.

[8] DAA works hard to grow commercial revenue. Where additional commercial revenue is created, this leads to lower airport charges, all other things being equal. DAA is fully committed to maintaining competitive airport charges, but the assumption that lower airport charges automatically lead to higher passenger volumes (implicit in the single till argument) needs to be challenged. At the same time as they lobby strongly for airport charges, airlines frequently impose large price increases on their customers which completely dwarf variations in airport charges. For instance, in commenting on Ryanair's Q3 2011 results (quarter ending December 2011) Ryanair's Chief Financial Officer commented as follows to Bloomberg on a 17% increase in fare revenue per passenger: *'Well 17% is actually less than €3, which is less than a pint of beer, so it's quite a small increase relative to the total cost of travel'.* http://www.bloomberg.com/video/85155686/

DAA proposes the following:

- A new business would be defined as a business not in competition with a business activity currently within the till.
- Where DAA planned to create a new business with linkage to the core aeronautical function, this would be notified to the users through a consultation process. In some cases, due to commercial confidentiality, the notification might occur after set-up or trading had commenced.
- Through the consultation process users would give their views as to whether they would wish to admit the business to the till. Generally speaking it would be expected that they would, but there might be instances where there would be concern about the business trading profitably on a sustained basis.
- In the event of agreement as outlined above, the business would be shared as between the till and DAA, i.e. 50% of the resulting EBITDA would be admitted to the price cap calculation (subsidising airport charges) and 50% would be retained by DAA outside the till.

The above proposal is consistent with the principle of profit-sharing put forward by CAR in CP1/2012. In this particular scenario, because the business would be a new one, the complication of adjusting the exit value to reflect the profit-sharing arrangement would not arise.

5. Incremental investment in existing till businesses

For the purposes of the discussion, DAA considers three different categories of investment in existing till businesses:

- Maintenance capex – This would be capex intended to maintain EBITDA, e.g. refurbishment of the existing multi-storey car-parks (MSCPs);
- Development capex – This would be capex intended to develop EBITDA, e.g. the proposal put forward in the last CIP for the Retail Logistics Centre;
- Major investment proposals[9] – This would be capex which would fundamentally change or augment an existing till business, e.g. a proposal to build an additional MSCP adjacent to T2.

5.1 Maintenance and development capex

An important feature of the proposals put forward by CAR is that, wherever a commercial investment proposed by DAA in the future was opposed by the users, what would fall for consideration for exclusion from the till would be not just the incremental investment but the entire till business. The reasoning behind this is that otherwise a scenario could arise in which a business outside the till (the incremental investment) could end up in competition with a business inside the till (the existing business) with obvious consequences for the incentive structure. DAA understands the logic behind this principle, and does not dispute it, but there are number of implications which should be considered.

The first implication is that the incremental investment would need to be large relative to the total size of the business for the consideration of excluding the entire business to be an appropriate response. For instance, it would be disproportionate to embark on a process of considering excluding the car-park business from the till in response to a dispute over a proposed €1m maintenance spend. This point is articulated by CAR in CP1/2012: '[F]*or investments that are small relative to the possible implications for the RAB, a decision by the Commission about what capital*

[9] In practice, the difference between 'development capex' and 'major investment proposal' would be arbitrary at the margin. Nevertheless, it is helpful to think in terms of distinct categories.

allowance, if any, to make may be preferable to parties to a decision by the Commission about what adjustment to make to the RAB so as to exclude the whole activity from the regulatory till. So parties may agree to exclude Dublin airport city from the regulatory till, but prefer that the Commission decide whether to include an allowance for a proposed €5m car-parking project rather than have car parking removed from the regulatory till and the Commission make a one-off adjustment to the RAB.' Accepting the precepts of the CAR's approach, this is sensible. However, the implication is that maintenance and development capex (as defined above, for commercial revenue projects) will have to continue to be allowed by CAR (or not) within the framework of the five-yearly price determinations. This still leaves the regulatory system with the problem of airlines expecting airport charges to be subsidised by commercial revenues but being unwilling to accept the necessary investment. To some extent, this problem is an unavoidable feature of the single till. The DAA proposal below would help towards ameliorating the situation:

- DAA proposes the establishment of a general Commercial Revenue Capex Allowance analogous to the general retail and operational capex allowances, €10.6m and €33.8m respectively in the 2009 determination. For instance, at present there is no capital allowance in the CAR determination to cover commercial revenue expenditures such as refurbishing campus advertising installations, creating e-booking links for car-parking, planning fees associated with long-term car parks, etc. These are examples of investments by DAA in maintaining and developing commercial revenues. Apart from the loss of revenue, it would simply be unfair and potentially inefficient for DAA to have to fund such investments out of its own pocket, and bear financing and working capital costs, while the commercial revenues in question are absorbed by the till. While consultation with users is appropriate for bigger ticket items, it would be inefficient and unworkable to have to consult on smaller miscellaneous spends.
- In general, the regulatory system should be wary of an overly mechanical approach to commercial revenue. In reality, commercial revenue generation is a dynamic process, requiring on-going effort to maintain and grow existing businesses and to replace activities whose appeal to the market may reduce over time. There is a constant flux in the composition of the business portfolio and in the competitive and demand conditions within businesses, an on-going process of replacing old with new. For instance, charging for wifi was initially seen as a good business opportunity, but is now routinely provided free by airports. DAA needs to be able to respond flexibly in the marketplace in order to exploit commercial opportunities and deal with intensifying competition and this should be allowed for within the regulatory system.

The second implication of CAR's conclusion (that an entire business will fall to be considered for exclusion from the till when a large investment is proposed by DAA and opposed by the users) is that the evolution of the till may be driven by investment opportunity rather than by principled reconsideration of what should or should not be within the till. DAA would like to leave open the possibility that other factors might prompt a reconsideration of elements within the till, for instance changes in market circumstances, business models, or passenger behaviour. In general, there is no reason for the implementation of the type of proposal put forward in CP1/2012, and in this submission, to preclude future evaluation of the till.

5.2 Major investment proposals

CP1/2012 seeks to resolve the regulatory impasse which arises with regard to the *'investment plans where the DAA and airlines disagree about the commercial viability of the project'*. At present, the only solution is for CAR to make a ruling allowing the investment within the till or not. This presents a difficulty for CAR: *'While we are comfortable applying regulatory oversight to investment proposals relating to aeronautical activities, we are keen to explore if there are alternatives to the Commission having to second-guess proposed commercial investments'*. And whichever way CAR rules on such

investments, parties are adversely affected. If CAR admits the investment to the RAB, airlines are forced to '*underwrite*' something they do not support. If CAR disallows the investment, DAA is precluded from backing its commercial judgement. If CAR seeks to reach a compromise, cutting the baby in half (so to speak), this also presents problems, as for example in the case of the fuel farm, where DAA has been granted an allowance it believes to be both economically inefficient and operationally unworkable. Nor is there currently any established mechanism or practice for excluding business from the till, although a proposed investment in hangar maintenance and associated revenue was specifically excluded at the last determination and the T1X investment was ring-fenced on an airport-charges-neutral basis (but is due to be reconsidered at the next determination). Hence CP1/2012, with CAR stating that it is *'willing to consider changes to the regulatory till where that might facilitate investments in commercial activities by the DAA that users of aeronautical services do not support'*.

In responding to CP1/2012, DAA has sought to envisage a decision process for excluding till elements that is choice-based and stepped, genuinely fair, and which avoids the inconclusiveness that almost invariably results from current consultation processes between DAA and users on capex projects. In putting this forward, DAA is accepting the premise that where an investment in an existing till business is disputed, it is the entire business – and not just the incremental investment – which falls to be considered for exclusion.

The process is described below and set out in graphical format in Appendix 1. By way of example, it might be useful to envisage DAA putting forward a proposal for a new multi-story car park (MSCP). The steps make frequent reference to the issues of exit valuation and cost separation, which are addressed in themselves in subsequent sections of the paper.

- Step 1

  DAA develops the investment proposal, which is presented to users through a consultation process. The proposal includes the financial details for the new investment, for example a new MSCP, and also sets out two scenarios for the entirety of the car-parking business, one with the new investment and the other on an as-is basis. The as-is scenario will set out the maintenance/development capex required for the business over the course of the time horizon. The proposal will also specify (a) the expected impact on airport charges of the investment taking place within the till (all other things equal, the return on the investment would reduce airport charges) and (b) the exit value of the entire business from the till. With regard to (b), the proposal would also outline in principle the treatment of cost separation issues, where applicable.

- Step 2

  Responding to the consultation, the users will have the options of (i) accepting the investment within the till, (ii) rejecting the investment within the till but accepting the proposed exit value, (iii) rejecting the investment within the till and rejecting the proposed exit value. It is suggested that DAA would collate and examine the responses of the users and decide whether the collective response was a (i), (ii) or (iii). It would be possible to specify explicit decision rules, for example requiring a majority decision by number of airlines, passenger volume, airport-charges value, etc. (A blocking response, for example undue objections to process, could ultimately be treated as a (iii).)

  In the case of (i) or (ii) above, the process would essentially be complete, albeit that there might be further work to be done on the details of exclusion in the case of (ii), e.g. with regard to the implementation of cost separation principles. A (ii) outcome would signal agreement with both

the proposed exit value and the cost separation principles. In the event that an airline was dissatisfied with either of these aspects it would choose response (iii) instead.

- Step 3

In the event of users collectively rejecting both the investment in the till and the proposed exit value, the proposal would be evaluated by an independent third party, for instance a known-brand accountancy firm. The third party would be appointed by CAR. There would be a standing terms of reference and methodology for the engagement, to avoid their being disputed on a case by case basis. The third party would review the financial profile for the two scenarios, i.e. the as-is scenario (including maintenance/development capex) and the with-investment scenario. The review would include validation or amendment of (a) the expected impact on airport charges of the investment taking place within the till, (b) the proposed exit value, (c) the cost separation principles and their likely operation in practice.

- Step 4

Reflecting the findings of the third-party review, the proposal would again be presented to the users with validated or amended (a) charges impact, (b) exit value and (c) cost separation principles.

- Step 5

At this stage, the users would have the option to accept the investment within the till or reject it. It would be understood that if the users chose to reject the investment, DAA would have the option to remove the entire business from the till **at the exit value specified by the third party** (including cost separation principles).

- Step 6

If the users reject the investment within the till, DAA would have the option of removing the entire business from the till or of leaving the business within the till but forgoing the investment proposal. DAA might choose the latter course in the case where it was unhappy with the exit value (including cost separation principles) specified by the independent third party.

5.3 Conclusion with regard to incremental investments in existing till businesses

The process proposals put forward by DAA in this section of the document are specific and detailed, but this should not be allowed to distract from the bigger picture. The intention is to ensure that significant value-generating investments are not blocked by impasse in the regulatory process, i.e. that investments which the users take a differing view on can nevertheless be undertaken by DAA without cost to the users in terms of airport charges (see discussion below). The importance of the stepped if-then approach to decision-making is that it provides a tool for overcoming otherwise intractable disagreement.

6. Exit value

A range of different approaches can be taken to the exit value of assets from the RAB, but there are two principal alternatives, i.e. RAB-carrying value versus disposal value. RAB-carrying value means the actual numerical value within the RAB of the assets in question. In the case of DAA's RAB, this would typically be the nominal cost at the time when the asset was created, indexed in line with CPI for the intervening period and depreciated in line with CAR's decided basis for depreciating that class of asset. Disposal value means the price that the asset would command in an open-market transaction.

In simple mathematical terms, for DAA to earn the return-on and return-of the residual capital value in the RAB, the exit price of an asset should be strictly in line with the RAB-carrying value. If the disposal value of the asset was higher than this, there would be a profit available from the sale. The specific exit value agreed determines how this profit is shared. If the exit value was the RAB-carrying value and DAA sold the asset on, it would earn all of the available profit (if there was a positive difference between the disposal proceeds and the RAB-carrying value). If the exit value was set at the full sale price, DAA would earn nothing from the sale and would have no incentive to remove the asset from the RAB. In the current context, we are not talking about sale of assets on the open market, but the example is helpful in crystallising the issues around exit valuation. There is no true exit value as such. What constitutes the optimal exit price depends on what it is we are trying to achieve. In this particular instance, the objective is to allow DAA to have normal commercial freedom and incentives in regard to investment decisions, to avoid value-generating investments being blocked by the regulatory process, and to avoid forcing users to accept into the till investments which they do not favour.

In CP1/2012, CAR's clearest proposal for exit valuation is the following: *'The proposed adjustments to the regulatory till seek to permit the DAA to invest in cases where the DAA and users have different attitudes to the risk of a commercial venture; they are not intended to change the level of airport charges. A change in the regulatory till should be net present value neutral, in terms of the stream of expected revenues from future airport charges, compared to a situation where the DAA did not proceed with the investment. We intend to achieve this neutrality goal by adjusting the RAB accordingly.'*[10] For the current purposes, this principle of airport-charges-neutrality is acceptable to DAA as a pragmatic approach. It would be rational for airlines to object to exits from the till which increased airport charges, and it is appropriate for the valuation principle to reflect this. In fact, such a valuation would equate more or less with a market valuation since it would be an NPV of the forecast stream of EBITDA the asset/business would earn within the till[11]. On the spectrum of RAB-carrying value versus disposal value, this proposal is at the disposal-value end.

Elsewhere in CP1/2012 CAR appears to deviate from the principle of airport-charges-neutrality. Take the following example with regard to Dublin Airport City (DAC). '*For a new activity, such as Dublin airport city, it may be that the only implication for the RAB is an adjustment to reflect the value of land removed from the regulatory till to facilitate the development. In this instance, reference could be made to recent prices paid for land in the vicinity of the airport and/or advice from real estate experts sought.'* If proceeding with DAC investment outside the till has no effect on airport charges, which is the case, then adjusting the RAB downwards would simply be a value-extracting (even punitive) measure. This would in effect mean that the principle of exit valuation would be that airport charges must be unaffected or go down, or that the till would take the airport-charges-neutral effect or the market valuation, whichever was the better. This would be opportunistic and unfair.

It is crucial to bear in mind that we are considering scenarios where DAA is putting forward a commercial investment which is available to the till if it so chooses. For the users to reject the investment suggests that they do not believe that it would positively impact airport charges (adjusted for risk). For the users to argue for a higher than neutral exit valuation suggests that they do believe that the investment can earn a positive return (adjusted for risk). To simultaneously reject the investment **and** require a higher than neutral exit price would be inconsistent. To make any

[10] CAR also writes: *'[W]e will consider whether removing the activity from the regulatory till might have the support of both users and the DAA. This condition is most likely to be satisfied in instances where the DAA proposes an investment for which users have reservations. In such circumstances, the goal would be to assign the risks (positive and negative) of the proposed investment to the DAA while ensuring that users are not asked to pay higher airport charges than they would have had to pay had the activity remained in the regulatory till and the investment not been undertaken.'*

[11] Net of on-going capital remuneration cost.

progress with the objectives set out in CP1/2012, it would be necessary to avoid any such having-your-cake-and-eating-it tendency, and this is one of the important features of the decision process put forward in 5.2 above. In the case where the investment within the till is rejected, the valuation of the exit is based on the as-is scenario. This is as per the extract from CP1/2012 cited above, namely: '*A change in the regulatory till should be net present value neutral, in terms of the stream of expected revenues from future airport charges,* ***compared to a situation where the DAA did not proceed with the investment****.'* (Emphasis added)

CP1/2012 emphasises the potential for *'divergent views'* as between airlines and DAA in exit valuation. DAA believes that the principle of airport-charges-neutrality can reduce the scope for such disagreement because it will condense the discussion to the financial profile with and without the proposed investment, which would be subject to independent validation as per the decision process outlined in 5.2. Based on an evaluation of the financial profile, the independent third party would specify the airport charges impact of the investment occurring within the till and specify the exit valuation based on the commercial EBITDA foregone (in the as-is scenario) if the business exited from the till.

In conclusion, with regard to exit valuation, DAA believes that an airport-charges-neutral outcome represents a route by which all parties can benefit. The risk with regard to future investment/return is removed from the till. The risk with regard to medium-term underperformance of the **existing** business is also removed from the till, but with the users nevertheless continuing to benefit from the existing cross-subsidy into the future. DAA is put in the position of being able to back its commercial judgement and undertake the investment in question. In doing so, DAA accepts the full commercial risk associated with the investment. Relative to this scenario, a higher than neutral exit price would simply represent an extraction of value (not yet generated) from DAA, transferred to users. This would give users additional return without any of the associated risk. The higher the extracted value the less incentive DAA would have to undertake the investment, to the point where a value-generating investment might be foregone. This would be an economic inefficiency, a situation in which no one benefits in contrast to a situation in which everyone could benefit.

7. Cost separation

DAA believes that the approach to cost separation put forward by CAR in CP1/2012 is too conservative and could seriously reduce the number of instances in which the principles in CP1/2012 (commercial flexibility through exclusion from the till on an airport-charges-neutral basis) could be applied in practice.

CAR writes as follows on this point: *'A necessary condition for us to consider excluding an activity from the regulatory till will be that we are satisfied that the activity does not give rise to a large proportion of shared costs with other activities in the regulatory till. Where shared costs are significant, excluding the activity from the till would require us to rule on arguments about what share of costs to allocate to the till at the time of each determination. The allocation of risks and returns from such an investment may depend critically on subsequent, potentially arbitrary, regulatory decisions about how to allocate these costs, rather than the actual merits of the investment. Future determinations could be dominated by parties arguing about the appropriate cost-allocation rules to use . . .'*

Cost separation for regulatory purposes is a routine feature for numerous regulated utilities. CAR is correct in saying that there is scope for disagreement and contention in this regard, but it is possible to create processes in which these matters are dealt with objectively and fairly (albeit necessarily

requiring some judgement), and we should collectively have the ambition to establish a system which facilitates economically efficient outcomes and not allow ourselves be deterred by process issues. Process should serve the economic objective rather than constrain it.

In the decision process put forward by DAA in section 5.2 above, wherever a business is put forward for (a) continuation in the till with a proposed investment or (b) exclusion from the till, the DAA investment proposal will outline the approach to cost separation that is proposed in the event of exclusion. It would be open to the users to reject the proposed basis for exclusion and this would then fall to be assessed by an independent third party, which would validate the approach or recommend amendments. Under DAA's process proposal, if the business did ultimately exit the till it would be on the basis of an approach to cost separation as validated or amended by the independent third party.

Cost separation can be looked at from a systematic accounting point of view. Approaches of this type would typically use economic principles such as long-run incremental costs. Such approaches can be appropriate – for example – where the purpose of the cost separation is for the price regulation of a player with market power in competition with new entrants. In the present case, the objective is different. We are talking about cost-separation for transactional purposes, i.e. for the purpose of determining the notional price of a business exiting the till. In this context, the cost separation approach can be seen as an in-built aspect of the proposed exit value, and this may allow for a simplified approach. We discuss this now in the context of the retail business at Dublin Airport.

8. Note with regard to the retail business

CAR writes as follows with regard to the retail business: '. . . [W]*e would want to be satisfied that it was possible to separate the costs and revenues from the rest of the Dublin airport accounts in a meaningful and straightforward manner. This is likely to mean many investments relating to retail activities, for example, remain in the regulatory till because of the arbitrary judgments that would be necessary to decide what share of the costs of terminal or pier should be allocated to the retail activity.'*

DAA would take the example of the concessioned business. Under the concession model, the concessionaire typically pays, as well as the concession fee, an additional percentage charge which is imposed to cover the indirect cost associated with the retail unit. The concession contract of course also specifies exactly which costs the concessionaire is directly responsible for. It would be possible in principle for the entire retail business to be concessioned out by DAA **within the till** (with CAR setting a forecast of EBITDA for the business for inclusion in the calculation of the price cap) or to be concessioned **out of the till** on an airport-charges-neutral basis. Even if DAA were not putting the retail business forward as a candidate for exclusion at this stage (see below), we would argue that this possibility should not be closed out for the future.

In CIP1/2012 CAR proposes than an entire business would fall to be considered for exclusion from the till in the instance where a significant investment in the business within the till is disputed. The retail business at Dublin Airport is very much a case in point. The capital allowance for retail refurbishments was rejected by airlines at the last determination. CAR ultimately allowed an amount of €10.6m, but this was less than 65% of the amount sought by DAA. A further allowance for on-going retail refurbishment will be required at the next determination. Retail is a competitive business and on-going refreshment and innovation is a feature of the market for high-street retailers and airport outlets alike. More significantly, the €55.9m investment (2009 prices) in T1X is due for reconsideration by CAR at the next determination. In sum therefore, the total level of investment on

the table for inclusion in the till will be very significant, and DAA will look to apply the principles set out in CP1/2012, i.e. that the investment be included in the till or that DAA would have the option to exclude the entire business, following the process set out in section 5.2 above.

9. Further comments on CP1/2012

DAA has the following further comments on other points made in CP1/2012:

- In a number of references, CAR indicates that agreement on exclusion would be a prerequisite to exclusion taking place. DAA believes that this would set the bar too high and would probably lead to nothing being excluded from the till and accordingly no advance with regard to the objectives set out in CP1/2012. Accordingly, DAA is putting forward the process described in section 5.2.
- CAR indicates that it would not see the fuel farm as a candidate for exiting the till because *'airlines indicated some support for investing in fuel farm activities at the airport'*. DAA itself does not necessarily consider the fuel farm a candidate for exiting the till, but *'some support'* is not sufficient. The investment project allowed by CAR was based on building two fuel tanks when three fuel tanks is universally recognised as the operational minimum, as specified for example by IATA. CAR also rejected the link-up to the Pier E hydrant and the establishment of the new into-plane on an airside rather than landside site, even though these features of the investment proposal demonstrate immediate economic efficiencies and environmental improvements (reduced emissions from fueller vehicles). CP1/2012 does not offer a way forward with regard to differences of opinion of this type.
- CAR puts forward the idea of a business being excluded from the till on a profit-sharing basis, implying a smaller exit value, but requiring clarity with regard to the basis on which risk and profit would be shared. DAA believes that this is a useful option to have available on a case-by-case basis. Under section *'4.3 New business not requiring capital investment'*, DAA's proposal is a profit-share.
- DAA welcomes CAR's assurance that a business excluded from the till would remain excluded, and that there would be no requirement for regulatory involvement in such businesses, e.g. consultation on investment proposals etc. However, CAR leaves open the possibility, in exceptional circumstances[12], of bringing a business back into the till. There would need to be certainty that this was not a mechanism for the till to re-absorb a successful business, having avoided the initial investment and trading risks.

10. Conclusion and next steps

DAA welcomes CAR's contribution in CP1/2012. The paper represents a constructive approach towards providing DAA the necessary flexibility to undertake commercial investments in cases where the airlines refuse to support the investments within the till, doing so without forcing airlines to 'underwrite' investments which they do not support. However, DAA also has reservations about CAR's proposals, in particular that they are overly limited by caution in a number of respects. This could have the effect, in practice, that few if any significant investments would 'qualify' for exclusion from the till. Another point of note is that CAR has steered away from anything that could be regarded as a review of the constitution of the till from first principles. We have made some brief points in this regard in **'2. Comment on CAR's overall approach to the regulatory till'**, but otherwise have addressed CAR's proposals within their own scope.

[12] CAR writes: *'The only exception we can see is if the commercial investment in question related to an activity that had evolved from an unusual marginal offering at an airport into something that all airports now offered. In these circumstances, the interests of prospective users might better be served if we capped the number of years for which the DAA was able to retain monopoly rents from the activity.'*

In responding to CAR's proposals, our document has focussed on different investment types in turn. With regard to **new businesses**, we looked firstly at those which have weak/no linkage to the core aeronautical function and concluded that these should be automatically excluded from the till by reference to a clear set of established criteria. With regard to new businesses which do appear to have linkage to the core aeronautical function, we distinguished between those requiring capital investment and those (fewer) not requiring (significant) capital investment. For ones that require capital investment, we propose a simple step process whereby the business is offered to the till through consultation with the users. If the users do not support the investment within the till, DAA would have the option to proceed outside the till. DAA also proposes a **Commercial Innovation Allowance** to cover smaller miscellaneous capital investments in order to promote commercial innovation on a risk-sharing, profit-sharing basis.

As a general point, DAA would not accept that user agreement should be a necessary condition of regulatory approval of investment within the regulatory till at Dublin Airport. There are a number of reasons for this, including that it is unworkable in practice because the airlines have demonstrated a tendency to oppose most investment. However, DAA does accept, as a matter of pragmatism, CAR's principle that the **process for till exclusion** will involve users expressing their agreement or disagreement with particular investment proposals. This requires some indication of how 'agreement' will be defined and measured, which issue is not addressed in CP1/2012. DAA suggests that agreement will be judged on the basis of written responses to a formal consultation process, with DAA concluding whether or not broad agreement was signalled by the users. Unanimous agreement should not be a necessary condition. It could be for CAR to review at the following determination – based on the record of the consultation – whether DAA was correct to conclude that there was (or was not) broad agreement. Given that there is some scope for uncertainty in such an arrangement, we also mentioned different possible decision criteria for consideration (e.g. numerical majority, majority by volume of passengers, etc.).

The case of new businesses (with some linkage to the core function) **not** requiring capital investment is typically over-looked. At present, the revenue from any such business would entirely be absorbed by the till and there would be no mechanism under CP1/2012 for such a business to be excluded from the till[13], in whole or part. This is a weak incentive structure, and it would be appropriate to put in place a regulatory environment which supports DAA's commitment to pursuing commercial revenue opportunities in a way that benefits all parties. DAA proposes a profit-sharing mechanism for businesses falling within this category.

The document then went on to look at the case of **incremental investments in existing till businesses**, and divides these into (1) maintenance and development capex and (2) major investment proposals. One of the core principles in CP1/2012 is that where a proposed investment is disputed by the users, it is the entire business that falls to be considered for exclusion from the till. The reason for this is to ensure that a scenario does not arise in which a business outside the till is competing with a business inside the till. DAA understands CAR's reasoning here, but would point to a couple of implications. The **first** implication – addressed in CP1/2012 – is that the proposed investment would have to be large relative to the size of the existing business for consideration of exclusion of the entire business from the till to be warranted. This in turn means that smaller investments – if disputed – could not benefit from the provisions of CP1/2012. The experience to date is that such investments will be disputed. There is a clearly observable pattern whereby airlines

[13] It would be sub-optimal from an incentivisation point of view for new business requiring capex to have an exit route from the till while the same business with a different, possibly better, financial structure not requiring capex on the part of DAA did not have an exit route from the till.

expect airport charges to be subsidised by commercial revenues, but are unwilling to accept the necessary associated investment. For smaller investments, DAA proposes a general **Commercial Revenue Capex Allowance**, analogous to the general retail and operations capex allowances currently in place. Such an allowance would also reflect the need for commercial flexibility and that instances/opportunities requiring capital investment will occur that cannot all be foreseen within the five-year planning cycle of price determinations.

The second implication of the mechanism for till exclusion put forward by CAR is that the evolution of the till may be driven by investment opportunity rather than by principled reconsideration of what should or should not be within the till. This ties back to DAA's earlier point about the limited nature of CAR's proposals. DAA proposes that CAR would leave open the possibility of future reconsideration of elements of the till for reasons other than a large, disputed investment, e.g. a change in market circumstances.

With regard to **major investment proposals**, working from CAR's premise, DAA puts forward a stepped process by which investments could be accepted within the till or the entire business excluded. The process is described in detail in section 5.2 and set out in graphical format in Appendix 1. It is intended as a fair, choice-based approach, which avoids the otherwise predictable log-jams. The key features of this approach are the following:

- Initial consultation by DAA with the users, setting out the financial profile for the investment, detailing the positive impact on airport charges if the investment would take place within the till and the proposed exit value (and associated conditions, e.g. cost separation) if the business was taken out of the till.
- Independent validation/amendment of the financial profile and exit valuation by an **independent third party** in the event of the users agreeing to neither the investment nor the exclusion in the first instance.
- Following the report by the independent party, the users would have the option of accepting the investment within the till **or** allowing the exit at the valuation recommended by third party.
- If – in the second instance – the users reject the investment within the till, DAA has the option of forgoing the investment or of exiting the business from the till at the valuation recommended by the third party.

Having addressed process, the document then proceeded to consider the key issues of exit value and cost separation. While a strong case could be made for **exit value** to be calculated on the basis of the RAB-carrying value of the assets in question, DAA recognises that this would be unlikely to be acceptable to airlines and instead accepts the pragmatic solution put forward by CAR that the exit value should be airport-charges-neutral (working from the scenario in which the proposed investment does not take place). DAA looks for this principle to be applied consistently and is opposed to any suggestion of exit value being airport-charges-neutral or higher, as this would be viewed to be opportunistic, unfair, and contrary to the objectives at the heart of CP1/2012.

With regard to **cost separation**, DAA's view is that CP1/2012 is too conservative. Cost separation is a routine feature of regulation for numerous utilities. The investment/exit process put forward by DAA includes detailing the approach to cost separation and having this reviewed by the independent third party where required. Cost separation can be managed as an in-built aspect of the exit value, and for this reason DAA does not agree with CAR's conclusion that the **retail business** at Dublin Airport could never be excluded from the till because of cost-separation issues. Airport retail businesses are commonly operated by third parties in both single-till and dual-till environments. This demonstrates that cost separation issues are readily dealt with by the market, and such treatment could be adapted for regulatory purposes. In fact, the retail business is one of the businesses which

DAA may put forward for till exclusion. This business also meets CAR's criteria for consideration for exclusion because of the large associated investment which is or may be in dispute (i.e. T1X plus the retail capital allowance that DAA will require for the period 2015-2019).[14]

Finally, DAA welcomes CAR's suggestion of considering a number of 'candidate investments' between now and the 2014 determination. In keeping with this, DAA intends to put forward for consultation a number of investments/businesses. In our view, an appropriate timeline for such consultations would be late-2012/early-2013. DAA is considering putting forward some or all of the following:

i. Retail business,
ii. Car-park business,
iii. Aspects of DAA property,
iv. Airport Genie (as an example of a business that might be covered in the future through a Commercial Innovation Allowance),
v. International consultancy business (as an example of business that would be automatically excluded from the till by reference to an established set of 'nexus' criteria).

DAA will also indicate, in this context, how it would envisage both the nexus criteria and the Commercial Innovation Allowance working in practice.

The argument might be made that to exclude all or most of the above from the till would effectively create a dual till. However, this would not be valid. The rationale for and defining feature of the single till is that airport charges are subsidised by commercial revenues. This would remain the case for any or all of the exits above, working from the proposals in CP1/2012 and the development of those proposals put forward by DAA in this document.

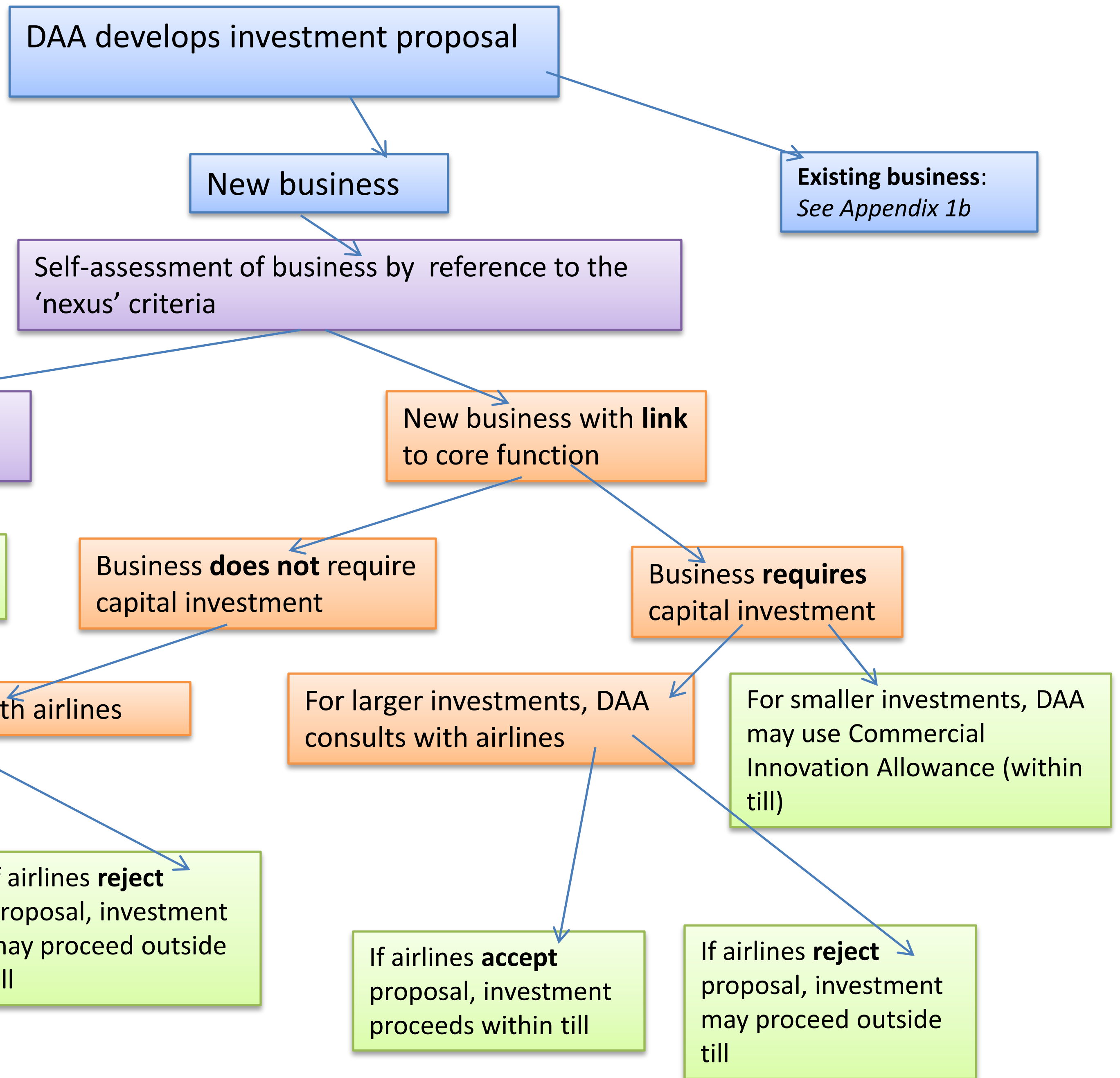
DAA suggests the above next steps on the basis of the process proposals set out in this document (i.e. in section 5 and summarised in graphical format in Appendix 1). As indicated, these proposals include the provision that DAA could opt to keep a business within the till in the event of its ultimately deciding that the established exit value and conditions were not favourable. Similarly, the DAA process proposals give the users the option of retaining within the till any investment/business considered promising. In this way, all parties are protected from finding themselves in scenarios considered adverse.

*

[14] Another important consideration with regard to the treatment of the retail business for regulatory till purposes is that retail is an area in which airports and airlines directly compete. This highlights a conflict of interest for airlines in engaging with the regulatory process re investment in the retail business.

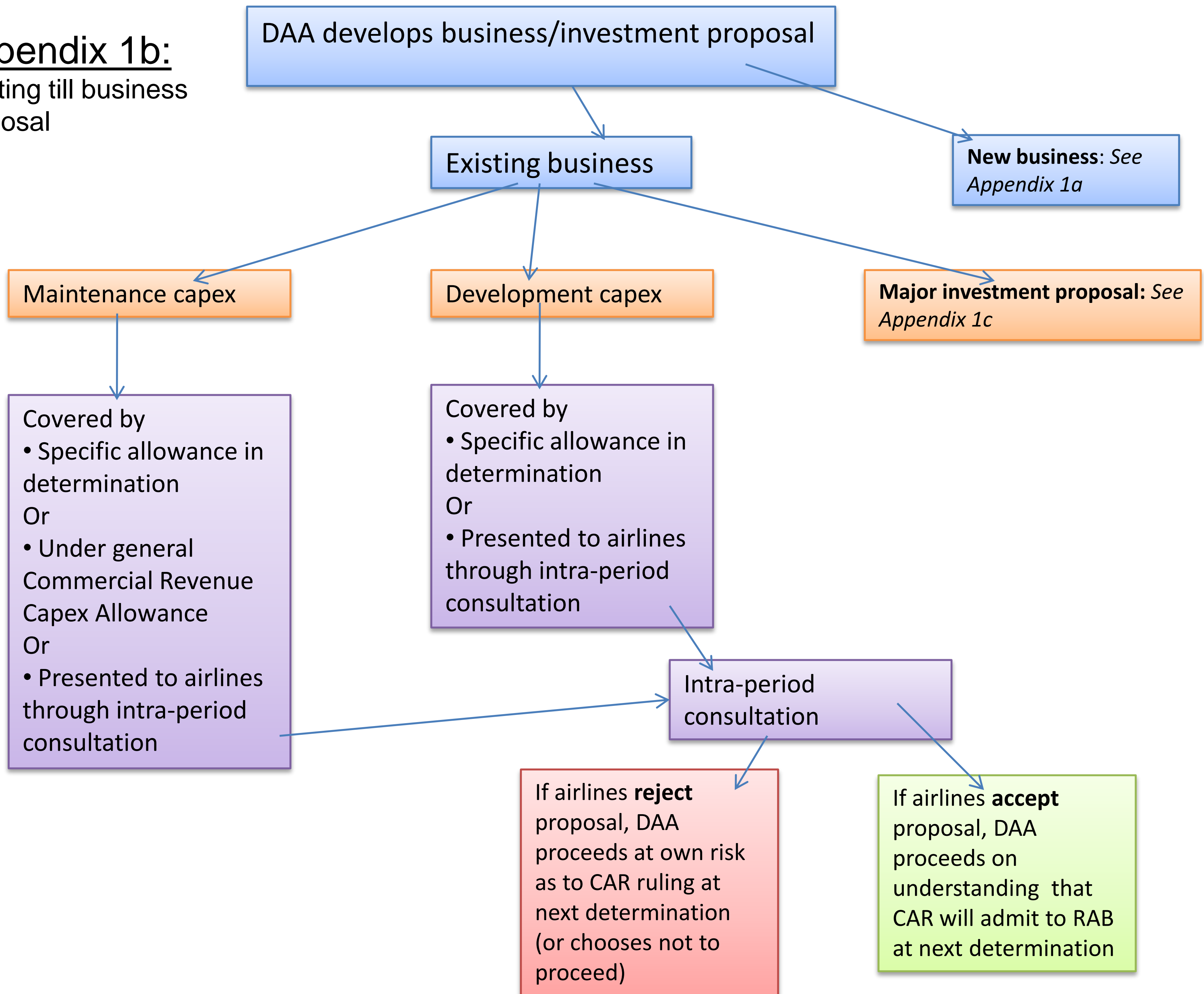
Appendix 1a:

New business proposal



Appendix 1b:

Existing till business proposal



Appendix 1c:

Major investment in existing till business

DAA puts forward major investment proposal (Step 1)

- Proposal for incremental investment
- Scenario for total business with investment
- Scenario for total business on 'as-is' basis
- Expected impact of investment on airport charges
- Exit value for business on charges neutral basis – 'as-is'

Step 2:

- Airlines accept investment within till
- Airlines reject investment within till and reject proposed exit value
- Airlines reject investment within till but accept proposed exit value

Review of proposal by independent third party (Step 3)

- Appointed by CAR with pre-agreed terms of ref. and methodology
- Reports on expected impact of investment within till
- Reports on exit value on charges-neutral basis – 'as-is'

Step 4: Airlines have option to accept investment within till; If they reject, DAA will have the option to exit the till at the value specified by third party

Step 5:

- Airlines accept investment within till
- Airlines reject investment within till

Step 6:

- DAA opts to forgo investment opportunity and leave business within the till
- DAA opts to exit business from till at specified value