



**Investments in Commercial Activities:
Capex Consultation Guidance and
Implications for the Regulatory Till**

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Commission for Aviation Regulation

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1. Introduction

- 1.1 This paper sets out guidelines on the Commission's proposed regulatory treatment of future commercial investments at Dublin airport. We use the term commercial investment to refer to investments intended to generate a stream of non-aeronautical revenues. The guidelines have been developed following a consultation about what costs and revenues to include in the regulatory till. They arguably build on earlier guidelines the Commission has produced setting out the consultation requirements for capital expenditure plans at Dublin airport.¹
- 1.2 The guidelines in this paper address situations where the business case for a proposed commercial investment by the Dublin Airport Authority (DAA) may be disputed by users. We hope they facilitate more constructive and effective capex consultation. Users and the DAA can agree to disagree about the commercial viability of a given investment proposal without either side feeling it has to convince the regulator that its assessment of the proposal is correct. The DAA will have incentives to undertake commercial investments and back its own judgment without users having to underwrite those investments for which they have reservations. The guidelines also try to provide parties with greater regulatory certainty about the treatment of capital expenditure at future price controls.
- 1.3 Two earlier consultation papers, and the responses to those papers, have helped to shape the guidelines in this paper. In late 2010 the Commission commenced a review of what activities to include in the regulatory till, having committed to undertake such a review in the 2009 Determination. An initial consultation paper, published in November 2010, re-visited a familiar debate in airport regulation: whether to use a single or dual till when setting a cap on airport charges, *i.e.* whether forecast revenues and costs associated with non-aeronautical activities should be included in the calculations.² Having considered the responses we received and reflected more generally on the matter, we decided against switching to dual-till regulation.
- 1.4 At the same time we acknowledged that there may be specific commercial investments where both users and the airport might support excluding the investment and subsequent costs and revenues from the regulatory till. A consultation paper published in April 2012 explored some of the issues involved and invited comments from parties.³ Four interested parties responded: Airport Council International (ACI Europe), Aer Lingus, the DAA and the International Air Transport Association (IATA). We met separately with Aer Lingus and the DAA in August to discuss their responses. The guidelines set out in this paper are broadly in line with the proposals that the DAA included in its response. They allow for the possibility of excluding certain future commercial investments from the regulatory till.

¹ See Commission for Aviation Regulation (2007) *CP8/2007: Discussion Paper – Consultation on the Approach to Capex Consultation*, www.aviationreg.ie

² See Commission for Aviation Regulation (2010) *CP4/2010: Defining the Regulatory Till*, www.aviationreg.ie.

³ See Commission for Aviation Regulation (2012) *CP1/2012: Future Investments and the Regulatory Till*, www.aviationreg.ie.

- 1.5 Perhaps the two most important problems parties identified with any arrangement which permits excluding certain commercial investments from the regulatory till are:
- a. how to avoid deadlock between the parties paralysing the process and
 - b. how to ensure that the DAA does not have perverse incentives to propose overly large commercial investments.

We address both of these concerns in the guidelines that follow.

- 1.6 These guidelines are intended to prove helpful and relevant for capex consultations the DAA may have with stakeholders between now and the next determination in 2014. Aer Lingus, in its response to our April consultation paper, wanted us first to develop and consult on principles for what is included in the regulatory till. We have concluded such an intermediate step is not necessary. The consultation process has already afforded parties an opportunity to comment on principles. Based on that earlier work, we have indicated that we generally favour single-till regulation, but we will consider excluding activities from the regulatory till if that better allocates investment risks from the perspective of all parties. A commercial activity will be included in the regulatory till, unless the DAA proposes an investment for which users have serious reservations about the business case.
- 1.7 The direct effect of these guidelines for future determinations may be modest. As the chart below illustrates, based on the DAA's 2009 Capital Investment Programme, these guidelines might have only applied to proposed investments accounting for less than five per cent of the DAA's proposed investments. But time saved prior to determinations in regulatory debates over the business case of a proposed commercial investment is time that can be spent reviewing other matters that may be relatively more important. The guidelines also clarify the approach we might take should the DAA develop proposals such as "Dublin Airport City", a possible commercial investment of considerably larger value which all parties in 2009 wanted outside the regulatory till.

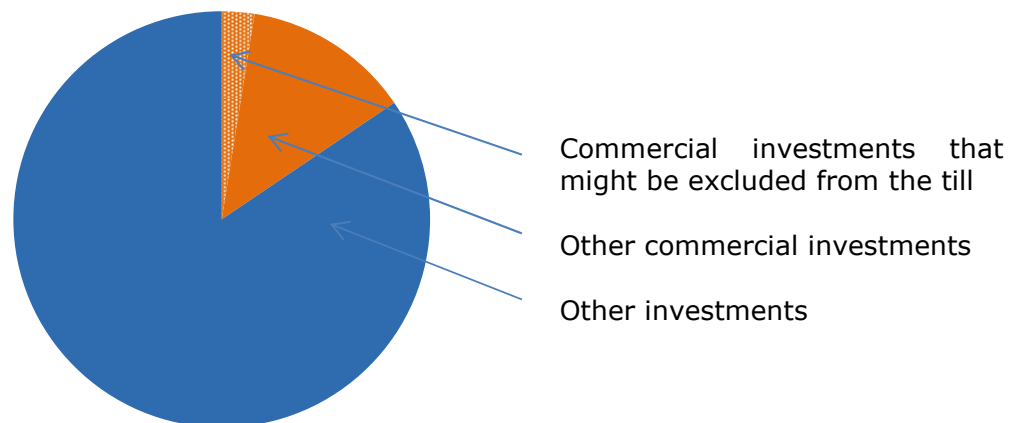


Figure 1.1: Share of commercial investments in DAA's 2009 CIP
Source: DAA, Commission calculations

- 1.8 The rest of this paper is structured as follows. The next section outlines the general process we envisage the DAA following when consulting on commercial investments. Discussion of some of the more specific issues that arise, notably the treatment of land values when adjusting the regulatory asset base (RAB), is left until section 3. Section 4 summarises the submission parties made to CP1/2012 and provides our response. Finally, section 5 concludes. The following sections assume that the reader is familiar with the material discussed in CP4/2010 and CP1/2012.

2. General process

- 2.1 When deciding whether to include the costs of the commercial investments in the RAB, we will look for evidence that the DAA consulted with users and that current and prospective users support the investment. This is consistent with what we have previously said about how we will treat all potential investments that the DAA might make.
- 2.2 It is important to recognise that consultations about commercial investments may affect future regulatory forecasts of operating costs and commercial revenues. Users wanting lower airport charges are unlikely to be best served by opposing all commercial investments that the DAA might propose.
- 2.3 For an investment proposal predicated on improving the airport experience (or even just preserving it), the airport operator's incentives to proceed with the investment should depend critically on whether current and prospective users are willing to pay higher airport charges to fund the investment. The rationale for consultation in these circumstances is to afford users an opportunity to give feedback so that developments really do reflect their needs. Once users have received sufficient information to reach a conclusion about the merits of an investment, the consultation on that investment can conclude.
- 2.4 In contrast, support for a commercial investment may depend on the perceived strength of the business case. Are users sufficiently confident that the proposed investment will generate large enough commercial revenues to permit lower airport charges if included in the regulatory till? Yet a finding that users have reservations about the investment's business rationale should not automatically deny the DAA the incentive to proceed with the investment. Because of this, the consultation need not necessarily end and the commercial investment be abandoned if users conclude that they do not support the investment being included in the RAB. Nor is it desirable that the consultations should have to continue indefinitely with the DAA and users trying to convince the other side of their case.
- 2.5 In circumstances where users have considered the proposed investment and remain unconvinced, the consultation could turn to a suitable "exit value" and what future costs and revenues need to be excluded from the regulatory till. We use the term exit value to denote a one-off downward adjustment to the RAB if the DAA proceeds with the investment outside the regulatory till. The exit value would seek to leave users indifferent

between the investment not proceeding, or the investment proceeding and the regulatory till being adjusted to exclude related commercial activities.

Key Features

These guidelines only apply for investments

- motivated by the prospect of generating non-aeronautical revenues
- that represent a significant amount in absolute terms and relative to any commercial revenues the DAA is currently collecting from similar activities
- for which accounting separation is relatively straightforward and
- where the generality of users have a common position.

They offer the possibility of users and the DAA agreeing to include an investment in the RAB, or agreeing to disagree about its merits and the DAA assuming the risks and returns if it proceeds with the investment outside the RAB.

Ex-post monitoring of the DAA's actual capital spend will continue.

- 2.6 The process we outline is for the case of a significant investment in an existing or new commercial activity, *i.e.* an activity that will generate non-aeronautical revenues. As a guide to what constitutes a significant investment, at the time of the 2009 determination the consultation meetings were confined to investments costing in excess of €5m.
- 2.7 Moreover, the guidelines only apply if there is a reasonable prospect that the final regulatory settlement will see the Commission exclude activities relating to the investment, including the commercial revenues associated with these activities, from the regulatory till if users oppose the investment. This means that the proposed investment should be large relative to any revenues the DAA has earned from that activity in recent years. For example, a proposed expenditure of €5.5m on new car parking facilities is unlikely to lead to all car parking revenues (€23.5m in 2011 alone) being excluded from the regulatory till should users oppose the particular investment. It also requires straightforward accounting separation rules if the investment proceeds outside the regulatory till. We do not want future determinations concerning the level of the price cap to depend crucially on finely balanced regulatory judgments about what share of costs or revenues to allocate to the regulatory till.
- 2.8 As with other investments, we would expect initially for the DAA to provide users with information about what it is proposing. This should include an overview of the project, a time line concerning when it will be delivered,

and how the DAA expects the investment to affect future determinations, *i.e.* what will be the capital costs of the project that might be added to the RAB and what incremental commercial revenues (net of any incremental operating costs) does the DAA expect to realise. The DAA should also suggest a revision to the RAB that might apply should users not support the investment being included in the regulatory till and the DAA still wants to proceed with it.

- 2.9 Once users have a basic understanding of the proposed commercial investment, we have identified three situations that might arise:
- a. Users may support the commercial investment proceeding and being included in the regulatory till.
 - b. Users may have reservations about the commercial investment and not want it included in the regulatory till.
 - c. Users may oppose the specific proposal of the DAA but believe that a similar, smaller scale commercial investment should proceed and be included in the regulatory till.

We outline, in turn, how we think consultation between the DAA and users might proceed and the likely regulatory treatment at subsequent determinations.

- 2.10 In practice, it may not always be the case that 100 per cent of users have a similar view about the merits of a commercial investment. There is not a single user. At the time of a determination, the Commission has to consider the interests of current and prospective users, with users defined broadly to include more than just airlines. In instances where users express conflicting views, the DAA will have to exercise judgement. If the DAA is unsure what inferences we might make about the interests of current and prospective users, given the feedback users are giving to the DAA, then it will be prudent to refer the matter to the Commission at the time of the next determination and not make irreversible investment decisions in advance. What follows assumes that the DAA has been able to infer a user view that represents the general consensus.
- 2.11 In all cases, we will continue to review any commercial investments that the DAA undertakes after the expenses have been incurred. We will treat the commercial investments included in the RAB the same as any other investment, comparing out-turn expenditure with the amount allowed at the time of the determination and deciding whether to make any adjustments to the RAB. For commercial investments excluded from the RAB, the review will be more limited. It will seek to ensure that the DAA's final investment is broadly in line with the project outlined at the time it was agreed to exclude it from the regulatory till. This check ensures that activities already generating commercial revenues are not removed from the regulatory till on the false premise of a commercial investment that users oppose and which the DAA ultimately revises significantly or does not undertake at all. We believe this check addresses a concern that Aer Lingus identified in its response to our consultation paper.

User agreement

- 2.12 For a proposed commercial investment that users support, the consultation can proceed to scrutinise the details, just as with other investments. The nature of the project would be agreed but parties might consult, for example, on possible alternatives and their cost implications and how different project plans might affect the airport's operations. The investment will form part of the RAB and expenditures as well as future profits will be included in the regulatory till, as shown in figure 2.1. Thus, the investment risk will be borne fully by users through airport charges.

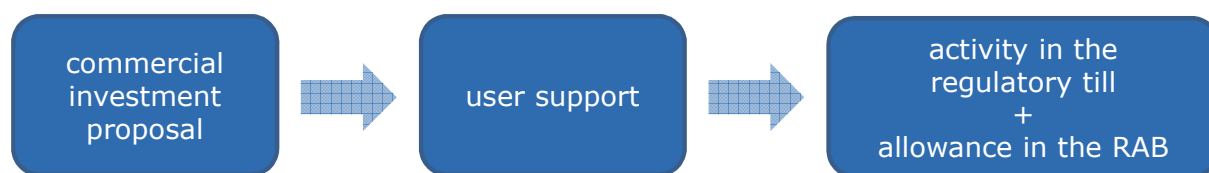


Figure 2.1: Consultation process for commercial investments users support

- 2.13 Under the heading of user agreement we also include situations where the airport and users agree to a different model of risk-sharing of the investment. If users have reservations about the investment they may not want to assume all the investment risk, as they implicitly do under pure single-till regulation once an allowance for the investment has been made. In such circumstances the DAA and users are free to discuss possible risk-sharing arrangements that are mutually beneficial. If they are able to reach an agreement, then we would give weight to such agreements when making subsequent determinations. For example, suppose the agreement envisaged the DAA assuming all the risk in return for guaranteeing to lower the revenues required from airport charges by €20m per annum. The calculations underlying a future determination might assume an additional commercial revenue stream of €20m per annum but otherwise ignore all costs and revenues associated with the investment.
- 2.14 The onus is on both the DAA and users to explore possible risk-sharing arrangements that might be mutually beneficial. If the parties fail to agree such arrangements, the Commission would normally expect to make a binary decision to either include or exclude the costs of the investment from the RAB. Should we exclude the costs of the investment from the RAB, we may also exclude subsequent forecast costs and revenues associated with that activity from the regulatory till.
- 2.15 If the parties conclude that they will not reach an agreement on risk-sharing arrangements around a given commercial investment and users are unwilling to support the commercial investment being included in the RAB, then one of the following two scenarios outlined below will apply.

User opposition to the investment

- 2.16 Where users doubt the business case underlying a commercial investment, but the DAA still believes that the investment is a good business

opportunity, we are keen to permit the DAA to proceed with the investment. This comes with the proviso that airport users will not have to assume any of the risks associated with the investment. Hence, in future price-cap calculations there will be no capex allowance included in the RAB nor any forecast operating costs and commercial revenues associated with the activity to which the investment relates.

- 2.17 A one-off downward reduction to the RAB may also be necessary to compensate users for removing activities and assets from the regulatory till. This is the reason why our guidelines envisage the DAA setting out an exit value when proposing a commercial investment that it might want to proceed with even when users oppose the investment's inclusion in regulatory calculations.
- 2.18 Should users not accept the DAA's proposed exit value, we suggest that users and the DAA appoint an independent third party to advise on a suitable exit value. The terms of reference for such an exercise would be for the DAA and users to agree. Depending on the commercial investment being considered, it might require an assessment of the value of associated activities in the regulatory till to date that would subsequently be removed from the regulatory till. It might also need to value any assets that have been included in the RAB but which the DAA needs to undertake the commercial investment, including possibly land.
- 2.19 If the DAA and users are unable or unwilling to agree to an independent third party and suitable terms of reference, then an impasse will have been reached and we will consider the investment at the time of the next determination. We will consider whether to include the investment in the RAB. If we choose to exclude the investment from the RAB, we might also decide on a suitable exit value, taking expert advice where necessary. Between determinations, it will be the responsibility of parties to consult on terms of reference, rather than rely on the Commission to set them. We want to encourage an environment where users and the DAA consult on matters of potentially mutual benefit.
- 2.20 The exit value that the independent third party reports back will supersede the value proposed by the DAA. At this point users will have to decide whether they want the DAA to proceed with the investment inside or outside the regulatory till, as shown in the figure below. On the basis of the exit value proposed, users should either support the investment being included in the RAB or accept the third party's exit value and grant the DAA the option to proceed with the investment outside the RAB.

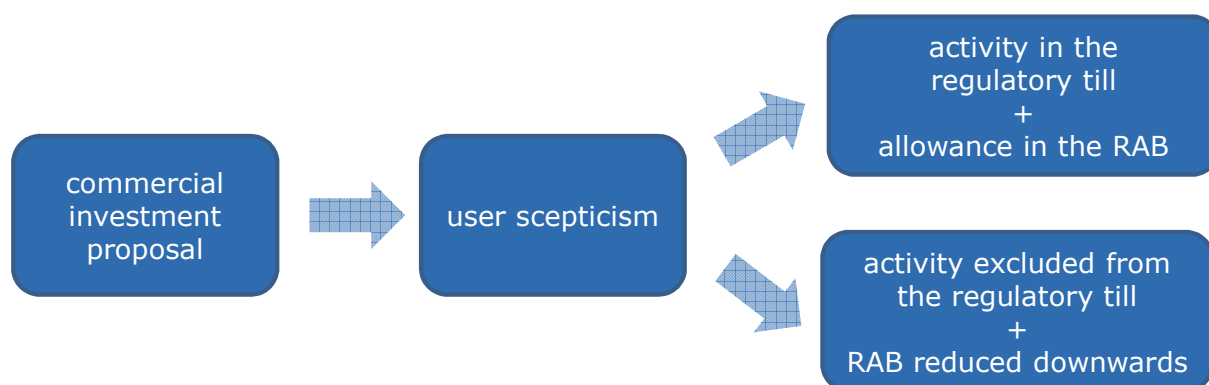


Figure 2.2: Consultation process for commercial investments users unsure about

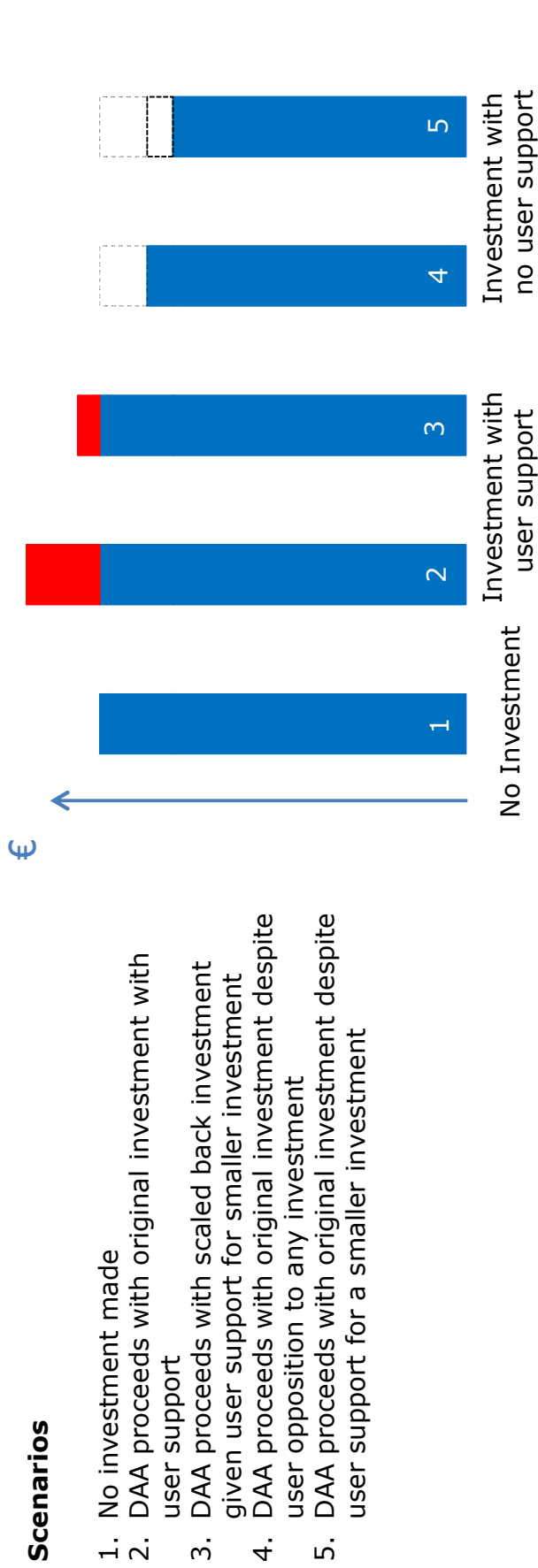
- 2.21 If users continue to oppose the investment and the DAA proceeds with it, then at the next determination we would normally expect to exclude the investment from the RAB, as well as costs and revenues associated with the activity. We will also give considerable weight to the exit value proposed by the independent third party when deciding whether to make a one-off adjustment to the RAB. All subsequent determinations will exclude from the underlying calculations forecast costs and revenues associated with such an investment.
- 2.22 Should users still oppose the investment and the DAA decides not to proceed given the independent third party's proposed exit value, future determinations governing airport charges will entail no adjustment to the regulatory till or RAB. The DAA would not have an indefinite option to undertake the investment outside the regulatory till if users opposed it at one consultation. If a determination has subsequently been made, we would normally expect the DAA to consult afresh with users if it wants to proceed with a similar investment at a later date. This is one reason why it is important that the DAA sets out a timeline for proposed investment during consultation with users, particularly for investments that might have a long lead-in time. We will refer to the timeline when assessing whether an investment by the DAA relates to a proposal it previously consulted on with users.
- 2.23 The exit value for a given business should only be assessed once every regulatory cycle (*i.e.* every four-plus years). This removes the DAA's incentive to seek repeated exit valuations until such times as it gets one with which it is happy to proceed with the investment outside the regulatory till.

User opposition to scale of the investment

- 2.24 Separate guidance is provided in cases where users oppose a specific commercial investment by the DAA, but believe that there is a business case for a similar, smaller scale investment. This might reflect a belief that a smaller investment will actually be more profitable. Or it might reflect a reluctance to assume the larger risks associated with a bigger investment should it not prove successful.

- 2.25 In such a scenario, the consultation may lead to the DAA revising its investment proposal. It could scale back to an investment that users supported. In this case, we would expect to make an allowance in the RAB for the investment at future determinations. Future price caps would depend on the commercial revenues that the investment generates and consequently users would implicitly bear the risks of the investment generating sufficient returns.
- 2.26 Alternatively, the DAA may wish to pursue its initial proposal. In this case, the exit value should reflect not only the value of removing commercial revenues from related activities from the regulatory till and possibly some assets, but also the revenues foregone from not proceeding with an alternative commercial investment that users would have supported. The steps to arrive at an agreed exit value would be as before: the DAA would make an initial proposal, and if that was not accepted parties would task a third party with determining an exit value. Users at that point could either indicate support for including the investment in the RAB or leave the DAA with the option to proceed at its own risk, understanding that the regulatory consequences are likely to be a downward adjustment to the RAB corresponding to the exit value and the exclusion of any costs and commercial revenues associated with the investment.
- 2.27 The key difference to the scenario outlined above, where users oppose the investment outright, is that the exit value has regard to the possibility of an alternative investment that users support. Figure 2.3 illustrates the different possible implications for the RAB and future forecast commercial revenues under different scenarios. The RAB and future forecasts of commercial revenues will be higher if users support the investment. The RAB will be lowest if the DAA decides to persist with an investment proposal notwithstanding user support for a more modest investment. The effect on future forecast commercial revenue is the same for scenarios where users opposed any investment in the activity, or just investment on the scale that the DAA proceeded with.

Updating the RAB



Future commercial revenue forecasts

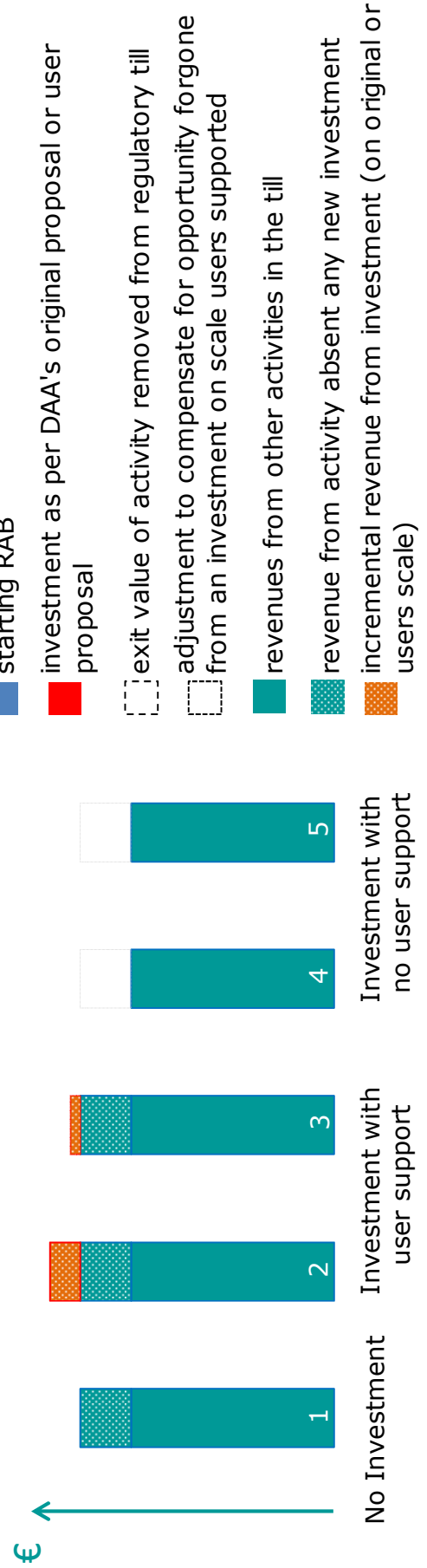


Figure 2.3: Regulatory adjustments to the RAB and future commercial revenues

- 2.28 Including this third scenario should reduce the incentives for parties to consult in bad faith. Whether the DAA will actually propose commercial investments that users only oppose because of the proposed scale remains to be seen. Nevertheless, the guidelines have sought to eliminate the DAA's incentive to propose an overly large investment merely as a means to have the activity excluded from the till. If a more modest investment makes better commercial sense, the increased exit value associated with undertaking the larger investment means that the DAA will have been better off scaling back its plans. Conversely, users' claims that they would support a less grandiose investment also need to be true. Following such feedback in the consultation, the DAA may invest on the scale that users have indicated they support. In these circumstances, we are likely to make an allowance in the RAB.
- 2.29 The option for users to advocate a revised scale of investment comes with obligations. It will not suffice merely to assert that for half the cost, the DAA could realise the same incremental revenues as the airport is projecting in its original plans. Users will need to demonstrate what aspects of the project can be scaled back, and how that might translate into cost savings. For example, if the proposal related to a hotel, users might suggest a reduction in the number of rooms if they thought the DAA's original proposal was premised on unrealistically large occupancy numbers.
- 2.30 The end of this report provides two schematic diagrams to show how these guidelines envisage capex consultation might work for commercial investments. Figure A1 illustrates the first two scenarios, *i.e.* it ignores the possibility that users may have reservations about the scale of the proposed investment. Figure A2 introduces this additional possibility. While the outlined process is intended to help parties structure consultations within a regulatory setting, arguably the most important factor if consultation is to work to the benefit of all remains a genuine willingness on the part of all to engage constructively.

3. Adjusting the RAB

- 3.1 There are some details that the previous section has not discussed. We address a couple of them here, relating to possible changes to the RAB: how we might adjust depreciation profiles, and how we might treat the value of land.
- 3.2 We acknowledge that other issues may arise where additional regulatory guidance would have been desirable. If parties consult on commercial investments between now and 2014, there will be an opportunity to identify some of these issues and we will be able to set out a regulatory position at the time of the next determination.

Adjusting the RAB when an activity is removed from the till

- 3.3 The exit value, discussed in the preceding section, is the amount we would envisage reducing the RAB by should the DAA proceed with a commercial investment that users would prefer outside the regulatory till. Its value will

include both the current cost value of assets that the DAA requires for its new investment and the expected net present value of future revenues from activities that have now been removed from the till.

- 3.4 Any RAB adjustments can only occur at the time of the price review, *i.e.* when making the determination. Because we only make determinations once every four-plus years, the adjustment to the RAB may be more complicated than simply subtracting the exit value. We would consider in what year during the preceding regulatory period parties had agreed to remove the activity from the regulatory till. We would then consider whether between that date and the next determination the price-cap calculations would have been different had we known of this adjustment.
- 3.5 The proposed adjustment to the RAB outlined in this paper underscores a point we have previously made: the RAB is not a fixed-asset account. There should be no expectation that it will always correspond to other parties' fixed-asset accounts. Instead, it represents a value of future claims that we intend to allow for in future determinations, by means of a depreciation charge.
- 3.6 An adjustment to the RAB will require a change to future depreciation charges. Ordinarily we would expect to adjust all future years' depreciation charges on a pro-rata basis. We would not intend that to alter the depreciation profile in a way that users in some years benefit from lower charges at the expense of users in other years having to pay more. Current users should not view agreeing to an exit value as a way of securing lower airport charges immediately to the detriment of future airport users.
- 3.7 Ordinarily we would not expect to re-introduce an activity to the regulatory till if parties have agreed that they would prefer the DAA to undertake investments in that area at its own risk. This means that should the DAA's confidence have proven to be well founded with the benefit of hindsight, the DAA will retain the profits. Future price-cap calculations will not factor in any profits from the activity. Only in exceptional circumstances, where the activity has evolved from an unusual marginal offering at an airport into something that all airports now offer, could we conceive of deviating from this policy. Moreover, we would only do so after consultation with users and the airport, and we would be mindful of the need to reward the DAA for potentially risky, but ultimately successful, commercial innovations.

The value of land

- 3.8 When estimating an exit value, one of the more finely balanced issues we have had to consider concerns the treatment of land at the airport required to undertake a commercial investment that takes place outside the regulatory till. The table below summarises some of the arguments for either valuing land at zero or at its current market price.

<i>Valuing land at zero</i>	<i>Valuing land at current market price</i>
Charges neutral when removed from the RAB	Reflects that land has some (implicit) value
It is idle land anyway currently creating no value	Third parties would have to pay such a price for the land.
Risk of a missed investment opportunity if valued too highly such that the DAA does not undertake an investment it otherwise would.	Risk of distorting investment decision, since all parties other than the DAA would have to consider the cost of land when deciding whether to proceed with an investment.
Regulatory simplicity since no need to value land.	Creates regulatory symmetry, since if the land is subsequently required for aeronautical services, it will be added to the RAB according to its current value.

Table 3.1: Arguments for and against using current value of land

- 3.9 After carefully considering these arguments, we have decided that adjustments to the RAB should consider the current value of land if the DAA requires the land for its commercial investment. There are two primary factors behind this decision. First, giving a value to land at Dublin airport better reflects market conditions and the opportunity costs of land. Second, it is also in line with the RAB roll forward principles where we stated that if the DAA sold land, it would have to sell it at the prevailing market price.⁴ Our decision means that the DAA has no incentive to favour undertaking commercial ventures vis-à-vis selling the land to a third party to undertake a similar venture.

4. Summary of Responses

- 4.1 This section briefly summarises the main issues parties raised in their written submissions to CP1/2012. Copies of the full submissions are available on our website. Our response to these points is included below.

ACI Europe

- 4.2 ACI Europe emphasised the need to tailor any regulation to the specific circumstances of the industry. It argued that the emergence of airport competition lessened the need for regulation, which had the potential to

⁴ See page 173, annex 3, Commission for Aviation Regulation (2009) CP4/2009: *Determination on Maximum Level of Airport Charges at Dublin Airport*, www.aviationreg.ie

distort such competition. ACI Europe suggested that we should undertake a deeper review of the actual competitive position of Dublin airport.

- 4.3 Notwithstanding its belief that we had failed to capitalise on the opportunity to undertake a more comprehensive regulatory review, ACI Europe saw some merit in CP1/2012. It welcomed the possibility that the regulatory regime might evolve such that non-aeronautical investment proposals have a realistic prospect of being implemented even where users oppose them. It emphasised the importance of developing a system of incentives to encourage all parties to engage constructively in consultation on investments.
- 4.4 There were three specific areas where ACI Europe expressed reservations.
- a. It did not believe that possible difficulties with cost-separation exercises were insurmountable. Therefore ACI Europe was keen that such perceived difficulties should not provide an obstacle to solutions that would otherwise reduce the need for parties to argue over investment plans.
 - b. It worried that users might abuse the system so as to prevent an activity from being removed from the regulatory till.
 - c. The possibility that we might re-introduce activities into the regulatory till gave bad incentives. Airlines might have an incentive to engage in "regulatory speculation", seeking to have activities added and removed from the till at different dates so as to benefit from fluctuations in the market valuation of the activity.

Commission Response

- 4.5 The Department of Transport, Tourism and Sport has announced plans to conduct a review of regulatory arrangements in the aviation sector in 2013. That is likely to be a more appropriate forum to debate the general need for airport regulation and what form it should take.
- 4.6 The guidelines developed in this paper have sought to give parties incentives to adopt a constructive approach to consultation on capital investments. Users do not have an indefinite veto over proposed commercial investments. If they are unwilling to support such an investment, the possibility exists that the DAA will ultimately make the investment with the associated costs and revenues outside the regulatory till.
- 4.7 Only exceptionally would we reintroduce an activity back into the regulatory till after a decision to exclude it. Parties should not lobby for activities to be removed from the till now in the hope that they will subsequently be able to argue in favour of reintroducing the activity to the till on more favourable terms at a later date: once an activity is outside the regulatory till, it is likely to stay outside the regulatory till.
- 4.8 We have limited our proposals to commercial investments where accounting separation is relatively straightforward. We want the business case for a commercial investment to determine whether it proceeds, rather than how the regulator chooses to adjudicate on a contentious cost-

allocation key. Where possible, we would prefer users and the airport to consult on the merits of such an investment and agree on who should assume the risks if it proceeds. But where users and the DAA are unable to agree on how to allocate costs and revenues, and are unable to agree on the merits of a commercial investment, we think that the regulatory focus should be on the competing arguments concerning the merits of the investment. It is more consistent with our statutory objective to facilitate the efficient and economic development of Dublin airport. Where possible, we want the DAA to be able to undertake investments in an environment where it has certainty about future regulatory intentions: we definitely would not want to exclude an activity from the regulatory till if there was uncertainty about how we might undertake accounting separation exercises at future determinations.

Aer Lingus

- 4.9 Aer Lingus was generally content with the views expressed in CP1/2012.
- 4.10 It believed that there was a need to establish a clear set of guidelines to decide on the limits of the single till. There were some activities which Aer Lingus thought fundamentally belonged within the single till because of material demand complementarities with aeronautical activities. Looking at the practicalities of cost allocation and the ability to reach consensus risked missing this matter of principle.
- 4.11 Aer Lingus also thought that the DAA might be able to manipulate a requirement for consensus. The airport might propose investments with a view to having an activity excluded from the regulatory till, rather than for fundamental reasons of economic efficiency.
- 4.12 On risk sharing, Aer Lingus did not want users to have to assume the risks of higher airport charges should an investment in an activity outside the regulatory till prove unsuccessful. It was interested in profit-sharing arrangements in instances where there were demand complementarities but the airport was proposing to invest more than airlines supported. It also supported such arrangements for commercial investments where the demand complementarities were currently weak but which might develop over time. Aer Lingus sketched out some ideas on profit sharing, but indicated that it thought this was an area where further thought might be necessary.

Commission Response

- 4.13 We have not been convinced by the need to develop a more formal set of principles. The previous consultation papers relating to the definition of the regulatory till have provided opportunities for parties to propose such guidelines. At this stage, we are satisfied that we have a practical proposal that also has underlying principles that are attractive: activities will only be excluded from the regulatory till where it is practical and where users oppose assuming a new investment risk.
- 4.14 Activities which give rise to important demand complementarities are unlikely to be removed from the regulatory till under our proposals. It would require the DAA to propose an investment relating to such an

activity that users did not support and which was large relative to existing revenues from the activity.

- 4.15 Parties have the option to discuss and develop risk-sharing arrangements. As Aer Lingus acknowledged, there are a multitude of possible arrangements. Rather than insist on a particular form, we have left it for parties to consult. The fall-back position, if parties cannot agree on such an arrangement, is that we will either include or exclude the activity from the regulatory till and require users or the airport respectively to assume the risk.
- 4.16 Our proposals have been refined to reduce the potential for the DAA to benefit from making over-sized investment proposals merely to game the regulatory set-up.

DAA

- 4.17 The DAA welcomed the recognition in CP1/2012 of different appetites for risk among airport stakeholders, and the emphasis on providing incentives to promote commercial investments that generate value. Nevertheless, it felt the proposals were too narrow in scope. It did not think changes to the till should be confined to future investments and thought that more general principles should be developed for when an activity would be within the regulatory till. It was also concerned that the conditions required to change the till were too restrictive, such that the proposals would have very limited practical effect.
- 4.18 Notwithstanding its reservations, the DAA outlined a possible step process that might guide discussions between users and the airport about commercial investments. The DAA set out how the process might lead to an activity being excluded from the regulatory till if agreement between users and the DAA about an investment could not be reached. Three categories of investment were identified: new businesses with weak or no link to aeronautical activities; new businesses with links to aeronautical activities; and incremental investments in existing till businesses.
- 4.19 The DAA identified the possibility of new commercial activities that only require operating expenditure. It was keen that the DAA have incentives to incur such expenditure, even though they would not be directly addressed in guidelines referring to capital expenditure.
- 4.20 A further refinement suggested by the DAA was the possibility of a "Commercial Innovation Allowance". This allowance would permit the DAA discretion to invest as it saw fit on maintaining and developing commercial activities, analogous to the allowances for general retail and operational capital expenditure in the 2009 determination.

Commission Response

- 4.21 The step process proposed by the DAA has influenced the guidelines we have set out in this paper. Our thinking on the DAA's proposals is therefore reflected in the guidelines we have developed here.
- 4.22 We are keen that the guidelines should be practical, and permit parties to consult on investment plans in advance of the next determination. In a

meeting with the DAA to discuss its response to CP1/2012, it became clear that all parties would likely want to undertake considerable further work before we could develop more general principles for when an activity would be within the regulatory till.

- 4.23 We have not specifically incorporated the DAA's proposals relating to a Commercial Investment Allowance and the treatment of commercial innovations funded purely by operating expenditure. The merits of both ideas arguably fall outside the focus of this consultation on the scope of the regulatory till and are better addressed at the time of the next price-cap determination. Our 2009 determination demonstrated a willingness to permit the DAA some discretionary capital expenditure allowances. Determinations are also the time when the office forms a view on an appropriate forecast allowances for operating costs; the DAA can make the case then that a higher such allowance should be set because of the scope for more than offsetting incremental commercial revenues.

IATA

- 4.24 IATA reiterated its support for single-till regulation.
- 4.25 It recognized that such regulation might not present the same investment incentives as an airport subject to competition might face. IATA supported users being protected from having to underwrite losses on the airport's commercial investments, although it was wary of a "cherry picking" approach by the airport. It argued that the overriding requirement was for users and the airport to agree what services, facilities and investments should be included in the RAB and the regulatory till, overseen by the Commission.

Commission Response

- 4.26 The guidelines in this paper seek to outline a framework that will allow users and the airport to agree on any changes to the scope of the regulatory till. We continue to have an oversight role: ultimately, it will be for us, when making determinations, to decide what costs and revenues to consider when arriving at a price cap. Any changes to the regulatory till will be made with reference to any consultations between users and the airport.

5. Conclusions

- 5.1 This paper provides guidance on how parties might consult over commercial investments. It is intended to encourage parties to consult constructively and indicates a willingness on the part of the regulator to behave flexibly where that will better permit users and the airport to allocate risks associated with commercial investments to those most willing to assume such risks.
- 5.2 The step process seeks to avoid consultations becoming deadlocked with parties arguing indefinitely over the merits of a commercial investment. The process also seeks to provide all parties with incentives to reveal their

true thinking about an investment. If users think a commercial investment has a good business case, they should support the investment to ensure its inclusion in the regulatory till; conversely, they should clearly state their opposition to investments where they have reservations and accept that the DAA can proceed with the investment at its own risk. For the DAA, there is no incentive to engage in “gold plating” by proposing commercial investments solely as a means to increase the RAB. Such investments will not be included in the RAB if users oppose them.

- 5.3 The rules and guidelines in this paper add to our previous paper on capex consultation. Unless and until we revisit these guidelines, parties should expect future determinations to treat commercial investments in a manner consistent with what we have outlined in this paper.
- 5.4 We do not envisage consulting further on issues relating to the definition of the regulatory till between now and the next determination. If necessary, we may refine or elaborate on the guidelines at the time of the next determination, so that parties can consult on commercial investments post 2014 with greater regulatory certainty. Any experience gained from consultations between now and the 2014 determination on possible commercial investments will clearly help parties identify if there are any shortcomings with the guidelines. We understand that the DAA has some candidate projects under the heading of commercial investments that parties might consult on. After 2014, we would expect to have guidelines in place that apply throughout the fourth determination and we are unlikely to revisit them for four-plus years.

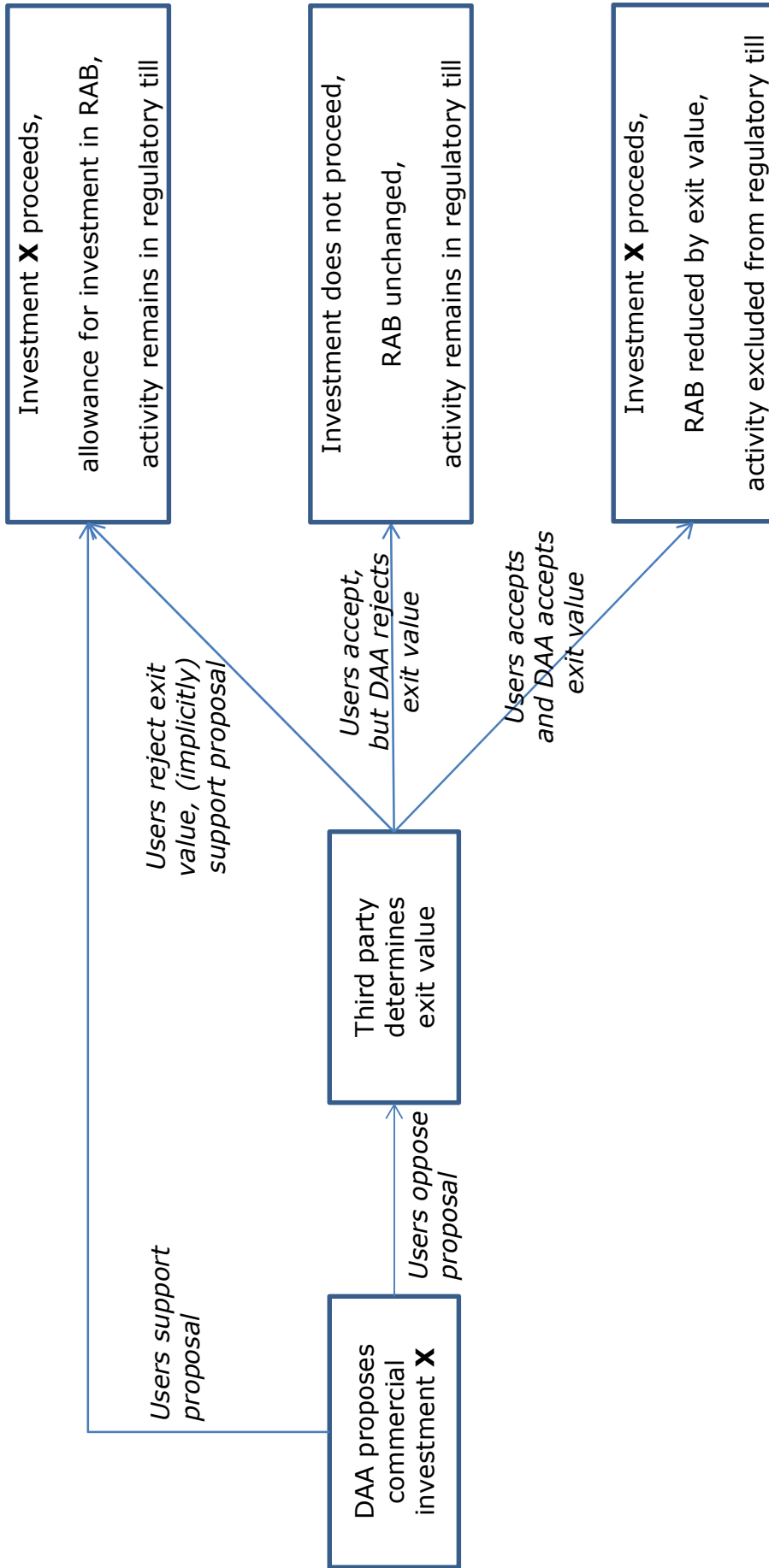


Figure A1: Decision tree for a commercial investment proposal

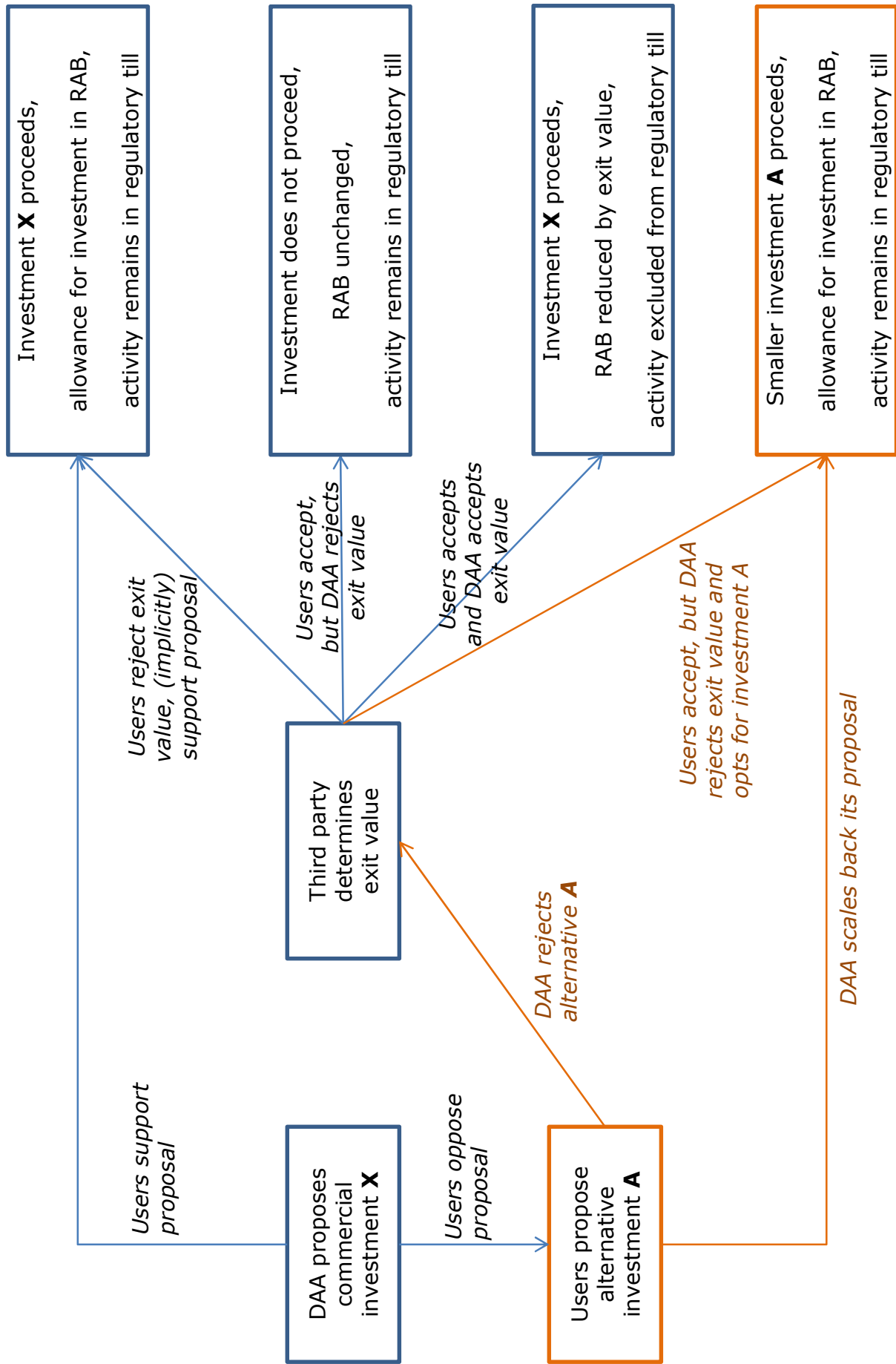


Figure A2: Decision tree for a commercial investment proposal (scaling possible)