Maximum Level of Airport Charges at Dublin Airport - 2014 Draft Determination

AER LINGUS' RESPONSE TO CP1/2014

Introduction

Aer Lingus is pleased to have the opportunity to respond to the Commission's draft proposals for the maximum level of airport charges at Dublin Airport to apply from 2015 to 2019.

We are pleased to see that the Commission's proposals reflect, to some degree the concerns expressed by Aer Lingus in our response to CP2/2103. A series of factors suggest that the next control period should be a period of falling charges.

At a high level, we would expect to see falling prices because:

- Opex costs are significantly below the levels predicted (and allowed for) in 2009.
- There is ample scope for further efficiency savings.
- There is no pressing need for further capacity expansion in the coming period.
- Growth in the wider economy should fuel modest growth in movements and passenger numbers;
- The cost of finance is materially lower than it was when charges were last set.

In this context we believe that there is merit in the Commission's proposed price limit that amounts to CPI-4.8% p.a. over the next five years. This goes some way to correct for the fact that Dublin Airport's charges have almost doubled since 2005. Benchmarking of aeronautical charges conducted for the UK CAA in 2012 shows how Dublin Airport's charges moved from 2006 to 2010 to being close to the top, relative to comparator airports[1]. Subsequent increases will have exacerbated this situation. In Aer Lingus' view it is essential that airport charges begin to fall significantly in real terms to re-establish Dublin Airport as an efficient, cost effective airport which can support economic growth in the wider Irish economy.

However, although Aer Lingus supports the Commission's determination to see airport charges falling in real terms, we consider that there are many areas in the

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1 Leigh Fisher (2012) "Comparing and Capping Airport Charges, Emerging Findings 18/9/2012.

Commission's draft determination where assumptions have been generous to DAA. This indicates that the Commission could and should consider tightening the price cap further.

The main points we raise are:

- **Passenger forecasts:** the assumed income elasticity seems low by the standard of international comparison;
- **Opex:** insufficiently challenging efficiency targets;
- **Historic opex:** the appropriate treatment of over-collection of opex (which was not efficiency) for the 2009-14 period;
- **Depreciation**: the lack of need for, or rationale for, the acceleration of depreciation from post 2019 to the 2014-19 period.
- **WACC**: set too high, given the evidence presented.

We further note that the proposed price limits do not allow for investment in a new runway. We reject the notion of a trigger to commence development of a new runway, whether at 25mppa or at any other level, until such time as a full analysis has been conducted on scope for more efficient use of the existing runways and the potential impact on the current cross runway configuration.

Overall we have identified generous (towards the DAA) elements of the Commission's draft determination which, if removed, would significantly reduce airport charges at Dublin relative to the Commission's proposal of CPI-4.8% p.a..

In fact, if the Commission had not chosen to accelerate depreciation from the period after 2019, we estimate that the price cap would be CPI-7.5% p.a., without changing any of the other assumptions. More challenging targets could perhaps increase the annual reduction by a further 2% p.a..

In the following sections we go through each of the major building blocks of the price determination. We provide Aer Lingus' view on the robustness of the assumptions made and the scope for the Commission to further reduce airport charges. While we are in agreement with much of the analysis contained in the Draft Determination, we focus in this paper on those areas where we believe the Commission should consider an alternative approach.

We cover:

- Passenger forecasts,
- Operating costs,
- Commercial revenues,
- Capital costs (including capital expenditure, depreciation and the cost of capital), and
- Quality of service.

In doing this analysis we have made use of the Commission's regulatory model which the Commission has helpfully made available on its website to estimate the likely impact of the changes we propose on the maximum charges limit for Dublin Airport.

Passenger Forecasts

The Commission has adopted its own passenger demand forecasts based on the results of new regression analysis and is predicting passenger numbers growing to 23.9mppa. by 2019.

This forecast impacts on the determination in a number of ways. In particular:

- Faster forecast growth in passenger numbers tends to reduce the allowed maximum per passenger charge, because costs, in particular opex, do not increase 1:1 with growing passenger numbers.
- Growing passenger numbers drive the need for capacity expansion – the key dependency in this case being the timing of the new northern runway.

We welcome the Commission's use of its own forecasts, which is in line with practice we have consistently supported in our previous submissions. We also note that the Commission's forecasts are, in practice, very similar to those presented by DAA[2], so the variation has little impact on the overall determination. We also note that in neither the Commission's forecasts nor those of the DAA, do passenger numbers come close to the threshold of 25m proposed for beginning work on the new runway.

Our main observation on the forecast is that the income elasticity parameter being used by the Commission (1.15[3]) seems low in comparison to other published evidence on elasticities.

For instance, a report prepared for IATA[4] suggests a range for income elasticities for the UK of 1.2 to 1.6 (with higher figures in the US).

Casual observation of the data plotted in the draft determination supports the idea that the income elasticity may be higher than the figure the Commission has chosen to use. Chart 3.3 (reproduced below) clearly shows that the change in passenger numbers, in percentage terms, from 2001 to 2013 is significantly

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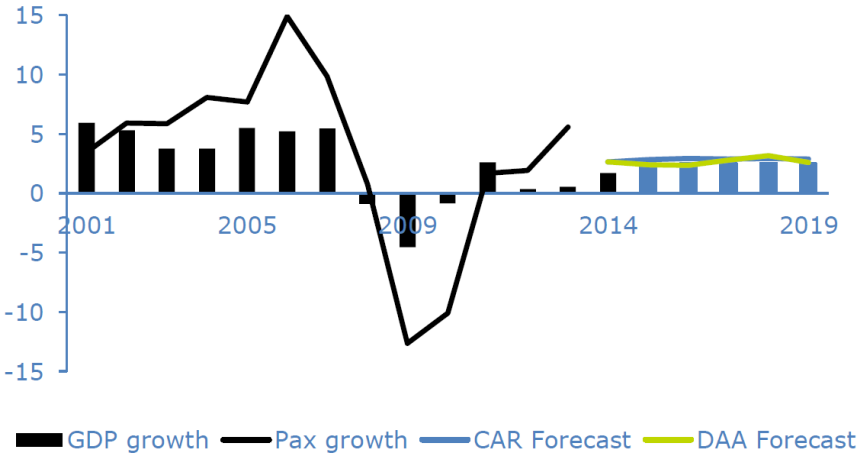
2 CP1/2014, Chart 3.2.

3 Ibid, Table 3.2.

4 InterVistas (2007) Estimating Air Travel Demand Elasticities - Final Report, available from the internet at Uniform Resource Locator: "https://www.iata.org/whatwedo/Documents/economics/Intervistas_Elasticity_Study_2007.pdf"

greater than the change in GDP in almost all years. This is true whether GDP is rising or falling.

Figure 1. Annual Change in Irish GDP and Dublin Airport Passengers (%)



Source: Central Statistics Office, DAA Regulatory Accounts and Regulatory Proposition, CAR forecasts

Source: CAR Draft Determination, Chart 3.3

Use of a higher income elasticity would imply a higher demand forecast and consequently lower airport charges.

We further note that the UK Department of Transport uses an income elasticity range from 1.2-1.7 for different markets, with an average of 1.3.[5].

Using the Commission's own model we have estimated the impact of assuming an income elasticity of 1.3 (towards the bottom of the IATA range), but using the same GDP growth forecast that the Commission has used. This would take projected demand in 2019 to 24.3m passengers p.a..

We calculate that, all other things being equal, this change would reduce the maximum airport charge in 2019 to €8.15 (from €8.35). This is equivalent to CPI-5.3% (as opposed to CPI-4.8%) for the control period.

We note that this higher forecast still leaves annual passenger numbers well below the 25m p.a. trigger level the Commission has proposed for commencing work on the northern runway.

We have wider concerns about this trigger and its application, which are covered in the section on capital expenditure below.

5 Department for Transport (2013), UK Aviation Forecasts, para. 2.16.

Operating expenditure

We wish to raise issues on two aspects of operating expenditure (opex).

Opex efficiency

The Commission has proposed a determination in which operating expenditure is flat in real terms over the control period, despite growing passenger numbers.

At first sight this may appear a challenging target. But Aer Lingus is concerned that, in practice, this may represent an over-lenient target.

This is most clearly demonstrated by two pieces of information in the draft determination.

First, at para. 4.2, the Commission notes that passenger numbers in 2019 are expected to return to approximately the same level as 2008 and that forecasted opex is also projected to be at the same level. This seems to be being presented as a confirmation that allowed opex figures are reasonable. But to Aer Lingus it raises the question – where is the evidence or expectation of efficiency savings achieved from 2008 to 2019? Over a period of 11 years, with efficiency at most 1% p.a. one would expect to see opex some 12% lower in 2019 than in 2008 for the same passenger numbers.

Secondly, the Commission seems to rely on Chart 4.4 to conclude that overall opex is reasonable, because the analysis shows that Dublin's opex is close to the sample average, and falling in the determination period. In our view, accepting Dublin's opex as reasonable on these grounds is overly generous to the airport. Other regulators frequently use a target based on the efficiency frontier, or the lowest decile or quartile, and expect the regulated company to achieve this target over a reasonable time period. In this case no such target has been set.

By way of illustration, while the Commission is asking Dublin to reduce its opex to €8 per passenger by 2019, inspection of Chart 4.4 suggests the lower quartile is around €7 per passenger. We do not feel the Commission provides a clear target for Dublin airport, or a clear rationale for why this sort of common benchmark-based target cannot be achieved.

We note also that the Commission presented some benchmark information comparing Dublin Airport to other types of organisation. We think that evidence from other sectors may be illuminating in terms of general trends in overall productivity. Indeed we think it is helpful to be reminded of the significant reductions in operating costs that airlines have to achieve year-on-year to remain competitive, and to contrast this with an opex proposal for Dublin that sees per passenger opex constant in real terms from 2008 to 2019.

Reviewing the expert opex report for the Commission[6], we are concerned that while the report is thorough in many respects, it is not clear that the judgements made have been sufficiently challenging, or translate into real opex efficiencies in the mid-range scenario that appears to be being proposed.

For instance:

- Dublin has a high ratio of staff to passengers (5th highest in the sample presented, slide 22). Is Dublin being set a sufficiently challenging target, aspiring to achieve industry best practice?
- Legacy staff – there are multiple references to legacy staff being significantly more expensive (e.g. slides 24, 28) and of the scope for very significant savings to be made (e.g. slide 26). But achieving these changes seem to have been put in the "too hard" category, so excluded from the mid scenario. This raises the question how long will DAA be given to sort out these issues and how long will its customers continue to have to pay for them? Companies operating in a competitive industry (such as airlines) do not have the luxury of delaying the introduction of such cost savings. Aer Lingus itself has faced similar issues with legacy terms and conditions and has had to meet these challenges head on.
- It seems that cost allowance is being made for real increases in wages. We accept the fact that some categories of earnings increase in real terms, but consider that usual regulatory practice is to expect the regulated company to find efficiency savings to absorb these increases.

In our view the Commission and its advisers have too readily opted for the mid-range efficiency scenario, leading to very modest savings by DAA. This it seems has come about by focussing on the obstacles to achieving efficiencies. While recognising that efficiencies require corporate effort to achieve, it is not for the Commission to focus on the obstacles to achieving efficiencies, but rather to set the DAA targets that are achievable (perhaps by reference to outside benchmarks) and a reasonable timeframe in which to reach these goals. The method that DAA uses to achieve the requisite savings should not be the Commission's concern, provided quality of service, in accordance with the Service Quality Targets continues to be maintained.

Overall, we think that at the Commission should be more clear about where Dublin Airport's long run opex target lies, and the time frame over which it is reasonable to expect it to achieve that level. In the meantime it seems reasonable to set Dublin the "high" opex target for the coming period. This is not excessively challenging, as, by our calculations it reduces annual opex in 2019 by only c. 2.5%. But this improvement would at least take Dublin Airport part of

6 SDG (2014), Dublin Airport Operating Expenditure Efficiency Study - Publishable Draft Report

the way towards the level of cost achieved by the lower quartile of airports, as described above.

Using the Commission's own model we have estimated the impact of applying the "high" efficiency scenario.

We calculate that, all other things being equal, adopting the high scenario would reduce the maximum airport charge in 2019 to €7.69. This is equivalent to CPI-5.4% for the control period.

Correction for Opex over-forecast in 2009-2014

One of the single biggest reasons why airport charges are bound to fall in 2015 is that the Commission significantly over-forecast annual opex in 2009-2014, with the opening of T2. This can be seen in Chart 2.1. Conservatively we estimate that Dublin Airport was allowed c. €130m in excess opex over the last control period as a consequence.

Notwithstanding the fact that this "error" is being corrected in the new opex forecasts, we are concerned that this cost differential, lasting for the entire control period, reflects a sum of money that Dublin Airport wrongly obtained at the last price review. The airport was awarded these costs in anticipation of cost increases reflecting T2. But the fact that opex never increased is strongly indicative of the fact that DAA was awarded opex that it would have known it did not need before the last regulatory period began.

In the circumstances the Commission should consider whether some or all of the benefit that Dublin Airport has wrongly claimed from this over-allowance of opex should be withdrawn. The fact that DAA continues to pad its regulatory plans unnecessarily is demonstrated by the excessive claims it has made in its most recent regulatory proposals. Withdrawing part or all of the benefit from the opex over-forecast could go part of the way to encouraging DAA to make more accurate cost projections in the future.

Using the Commission's own model we have estimated the impact of withdrawing the benefit of this over-allowance, by reducing the opening RAB by €130m and reducing the depreciation schedule accordingly. The impact clearly depends on how quickly this adjustment is worked through. We have modelled doing so over 5 and 10 years.

We calculate that, all other things being equal, this change would reduce the maximum airport charge in 2019 to €7.18 if the reduction in RAB is effected over 5 years or €7.60 if the reduction in RAB is effected over 10 years. This is equivalent to CPI-7.6% (5 yrs) or CPI-6.6% (10 yrs).

Commercial Revenues

Aer Lingus approves of the Commission's general approach to forecasting commercial revenues, using estimated trends and benchmarks. We note that Dublin's performance on commercial revenues is close to the upper quartile, and for this reason a forecast that maintains commercial revenues constant per passenger in real terms seems sensible.

We also agree with the Commission's approach to new commercial projects[7]. These should be self-funding: their inclusion in the determination should never lead to a higher limit on airport charges.

Capital Costs

Capex

Before commenting on the detail of the CAR's findings on capex, we would acknowledge the quality of the information relating to the proposed capital expenditure provided by the DAA during the capex consultation process. However, as we pointed out during the consultation process, the DAA failed to provide adequate justification for many of the proposed projects. However, we believe the Commission has exercised prudent, balanced and evidence-based judgement in assessing these projects.

As regards the treatment of expenditure in the 2009-14 period, Aer Lingus supports the Commission's approach to over-spending on specific items and agrees that the identified items should be disallowed from the RAB[8]. We agree that these principles protect current and future users and consider that the Commission is applying them appropriately in this case. We also endorse the Commission's approach to the disallowal of spending when an output has not been delivered[9]. We believe these steps underpin the incentives for DAA to be efficient and to deliver on its commitments.

Looking to the 2015-19 period, the capex plan allowed for DAA is €308m. This compares to c. €150m that was both allowed and delivered in period 2009-14 (including the forecast for 2014).

In Aer Lingus' opinion, this plan, overall, is larger than is necessary for a period that involves no justifiable case for significant capacity expansion. Indeed, the Commission seems to recognise this fact in para. 6.30, which notes that in the past DAA has only exceeded this level of capex in a five year period when it was

7 Para. 5.13.

8 Para. 6.5.

9 Paras. 6.13-6.17.

building T2. We consider that the Commission could have been even more challenging in asking why a record investment plan should be proposed in such a period.

Aer Lingus has maintained a consistent and principled position throughout the Capex Consultation process and maintains that position. In summary, we support projects where the scale of the project is justified on at least one of three grounds, namely:

- investment is mandatory in the current determination period (as a result of a regulatory/legal requirements) or is demonstrated to be necessary to maintain the value of the capital asset;
- where the investment provides for an airport or airline operating efficiency; or
- where there is a proven capacity requirement.

We believe that CAR's approach in its assessment of the DAA's proposed capex programme is consistent with this approach. We are therefore broadly supportive of the CAR's conclusions although we believe that the overall allowance for capex is more than generous to the DAA and should not be increased under any circumstances. We are mindful that it is not the CAR's remit to micro manage the airport operator in terms of individual projects. We therefore support the CAR's approach as set out in para 6.38 to allow the DAA flexibility within the different capital groupings in the deployment of capital, subject to the designation of certain projects as deliverables. In general, we believe that the Commission has struck the right balance in the various groupings but would make the following comments:

- We agree with the binary approach adopted by the Commission to either allow or disallow expenditure for a project as proposed by the DAA in its entirety. In relation to the Business Development Grouping, we agree that the total amount of €35.2M is more than an adequate allowance for this grouping. However, on the basis of the justification for these projects as provided by the DAA, we do not see the need to designate any specific projects in this grouping as a deliverable as the projects in this grouping are intended to meet the requirements of users. Consequently, we would propose that the DAA should have flexibility to allocate among all projects, (including those currently designated as deliverables, and those which have been disallowed) the allowed spend in its discretion exercised in consultation with users.
- Specifically in this regard, we refer to the Bus Lounge Facility and to the T2 Transfer Facility within the Business Development Grouping. In the case of the Bus Lounge Facility, we feel that this is oversized, while the transfer facility requires expansion to meet both current and future

requirements. We therefore believe that the DAA should be free to redirect monies allocated to the Bus Lounge Facility to expand the T2 Transfer Facility. For instance, in our view the bussing lounge is at least 50% oversized, and monies saved on a reduced bussing facility could be used for more modest (in comparison to DAA's plans) expansion of the transfer facility based on demonstrated demand. By adopting this approach, we believe that the Commission can address both these anomalies by giving the DAA maximum flexibility within this grouping. This approach would be consistent with the CAR's remit to control overall spend rather than micro-managing individual projects.

- Also within the Business Development Grouping, we support the project relating to the Terminal 2 HBS Level 3 Screening to the extent that this is mandatory. However, as this project will not be implemented until 2020 (i.e. until the next determination period), we agree that the cost should not be recovered until the next determination period.

- In relation to those projects which the DAA has considered as Trigger Projects, we support the approach that only justified projects which are implemented within the current determination period should be recovered during this period. Had the DAA proposed triggers based on implementation (rather than the commencement of work), we believe that the Commission may have seen fit to allow such projects. For instance, we support the realisation of the efficiency gains associated with the project for Additional Line Up Points on runway 10/28 and would support a trigger project based on the completion of this work. However in view of the phasing required to deliver these efficiencies as described by DAA on page 185 of the CIP, no material benefit is likely to accrue during the forthcoming determination period.

Comments on the northern runway trigger

Aer Lingus fully understands that when traffic reaches a certain level at Dublin Airport the DAA will have to commence development of the new northern runway.

However, we do not accept that there should be a trigger to commence building of the northern runway.

We accept that the runway is sometimes congested at peak departure times and that demand has become more skewed towards the peak in recent years. Nevertheless, we consider that the DAA's plans have failed to adequately take into account the scope for more efficient use of the existing runways and increasing average aircraft size.

As regards peak runway capacity, the DAA state that this will be 38 movements per hour in 2014[10]. This compares to Gatwick's Capacity Declaration for the summer of 2014, which shows a maximum 55 movements per hour. Gatwick is currently achieving more than 240,000 runway movements per annum off a single runway compared to Dublin's c. 170,000. Furthermore, Gatwick is projecting being able to achieve c. 280,000 movements by the early part of the next decade, carrying more than 40mppa[11].

Factoring in that the average aircraft size at Dublin is smaller than Gatwick, but also allowing for slow steady growth in this average, of around 1% p.a., then performance to Gatwick-like levels might accommodate 35mppa. on the existing runway, compared to DAA's figures of between 27mppa and 28mppa.

These are very rough calculations, but suggest that more efficient use of the runway infrastructure at Dublin could delay the need for another runway for a significant number of years, which would push the need back to the 2025-29 regulatory period at the earliest.

Given these doubts and the scope for more efficient use of a single main runway that is demonstrated by Gatwick, we consider the 25mppa. trigger to be completely inappropriate for DAA to commence work on a runway that would be expected to be delivered within another three years.

Given that the runway is manifestly not needed in the current period, and the scope for efficiencies mean that it may not be needed in the next period, we consider that the Commission should cancel the current trigger for starting runway development until it has properly analysed the scope for more efficient use of the runways, and the operational impact that a new northern parallel runway would have on the current two runway cross configuration at the airport.

In the event that this review confirms the need for a trigger in the current period then this decision could be the subject of an interim review.

Depreciation

We note that the Commission's proposals involve the smoothing of the X factor in the CPI-X formula to -4.8% p.a.. This is achieved by accelerating c. €90m of depreciation from after 2019 to before.

The Commission does not explain the rationale for this adjustment. We note that it does not cite financeability as the rationale for bringing this depreciation forwards.

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10 DAA CIP Proposals 2015-19, p. 64.

11 Gatwick Master Plan, July 2012.

Aer Lingus has two specific challenges to the approach adopted by the Commission.

First it is common for regulators when smoothing movements in prices to adopt an NPV-neutral approach *within* the price control period. It is less common to move revenue from the next period to the current one, simply to smooth price movements. While we recognise that the adjustments the Commission has made are NPV neutral in the long run, it does have the effect of accelerating c. €70m of revenue (undiscounted) from after 2019 into the 2014 to 2019 period. If the Commission is determined to smooth price movements, and financeability is not the reason for this adjustment, then we would recommend the Commission considers an adjustment that is NPV neutral within the 2014-2019 period.

Secondly, we are not convinced that smoothing the price movement over five years is necessarily the right approach in any event. The efficient level of prices can be expected to be significantly lower from 2015 because of the reduction in allowed opex and the fall in financing costs. This would be more consistent with a P_0 price reduction, followed by a smooth X thereafter.

Removing the depreciation adjustment in the Commission's model does not change significantly the maximum price in 2019, but the profile is very different. It is consistent with a P_0 reduction of CPI-17.3%, followed by an average limit of c. CPI-1.5% for the following four years.

WACC

The Commission has estimated a range for the pre-tax real WACC of 3.8% to 5.9%. The point estimate used for the draft determination is 5.8%. This compares to the rate of 7.1% allowed in 2009.

The methodology used to estimate the cost of capital (e.g. using CAPM) is standard and consistent with previous decisions.

Risk-free rate

The Commission has estimated a range of 0% to 1.5% and uses a point estimate of 1.5%. The estimate of 1.5% is consistent with other regulatory decisions (e.g. UK). But at the same time the CAR's reasoning for choosing a value at the top end of the observed range is not made clear. The Commission considers:

- The yields on AAA Eurozone countries;
- The yields on Irish government bonds; and
- The case of a country risk premium.

The data on the AAA Eurozone countries over the past 2-3 years supports a value of zero. The current yield on Irish government bonds is below 1.5% but the average of the past 2-3 years would be higher (c.3%). Separately, the

Commission concludes that there is no case for a country risk premium and have not included one. What the Commission does not address therefore is why they have chosen a point estimate of 1.5%.

A case can be made for a risk-free rate below the top-of-the range. For example, the CAA used a range of 0.5% to 1.0%. Given the evidence the Commission has presented, it should adopt a lower estimate for the risk-free rate or provide clear justification for its decision.

Equity risk premium

The chosen range of 4.5% to 5.0% is based on historic data and is reasonable. The point estimate of 5.0% is also consistent with other regulatory decisions.

Total market return

The Commission notes that its point estimate of the market return (1.5% plus 5.0%) is the same as the UK CMA in NIE. They also state that *"Where we have adopted a lower (higher) risk-free rate, our equity risk premium would have been higher (lower), so as to preserve a total market return that is around 6.5% of this draft determination." (page 60]* The meaning of this statement is not entirely clear but it implies that if they had chosen a lower risk-free rate they would have also chosen a higher ERP. This is odd as both figures have been chosen at the top of the range. It is also inconsistent with Commission's earlier statement that this parameter is a cross-check and not determinative. It would be useful for Commission to clarify this position.

Asset beta

The Commission has chosen a value of 0.6 from a range of 0.5-0.6. The range appears reasonable and is consistent with regulatory decisions for Heathrow and Gatwick. The Commission has not explained why the top-of the range value was used. It even stated that *"We think there is an arguable case for a lower beta, perhaps as low as 0.5."*

Appendix 5 provides some detail on their beta estimates for airports. These airport beta have not influenced their decisions but we have are some serious reservations about the estimates:

- First, the betas are estimated against a UK index rather than national indices – this is not standard practice and is likely to understate the beta estimates;
- Second, the estimated asset betas for Auckland and Sydney Airports are implausibly low.

We do not consider that correcting for these issues would alter the case for the estimated range of 0.5 to 0.6. But the Commission might seek to clarify its reasoning in this area.

Cost of debt

The real cost of debt range is 2.5% to 3.0% with a point estimate of 3.0%. This decision is poorly explained. The Commission states that they estimate the figure with reference to the cost of new debt assuming a BBB rating. The cost of embedded debt was explicitly not considered. The Commission presents two pieces of evidence on the cost of new debt:

- Latest yields on European BBB bonds are 1% in real terms;
- The current yields on ESB BBB+ 2024 bond is 2.78% nominal.

Neither of these figures supports a 3% real cost of debt. The Commission states that "the market evidence suggests that a real cost of debt for Dublin airport (assuming a triple [sic] BBB rating) in the range 2.5% to 3.0% is reasonable." Given the approach and the data provided, a real cost of debt at 3% seems unreasonable.

There is a case of taking a time series view on the cost of debt, to avoid excessive volatility in the cost of capital. However, a figure based on the past five years of historic data would support a figure well below 3%.

Overall

The Commission has adopted a top-of-the-range figure for all of the parameters, without clear justification or evidence.

Adjusting just two of the parameters (cost of debt and beta) to be the middle of the range rather than the top would reduce the WACC to 5.38%. This would put the point estimate at the 79th percentile of the range which, coincidentally, is where the CAA set the point estimate for Heathrow.

We calculate that, all other things being equal, reducing the pre-tax WACC to 5.38% would reduce the maximum airport charge in 2019 to €8.15. This is equivalent to CPI-5.3% for the control period.

Other Issues

Price Differentiation and Off Peak Charges

We note the Commission's views on these issues and we welcome the fact that it does not propose to reopen them for the forthcoming determination period. Aer Lingus has set out at length in many previous submissions the reasons

why differential terminal pricing and off peak charges are not justified and we do not propose to repeat these arguments here.

Quality of service

We believe that the Commission has dealt with this issue comprehensively and in a balanced way, and we generally support the conclusions made in the Draft Determination. While we are somewhat disappointed that the Commission has chosen not to introduce service levels in respect of transfer security search queues, we understand the rationale that the DAA is subject to competitive forces in this regard. However, we suggest that the Commission should, at a minimum, make it clear in the determination that the DAA are obliged to ensure that the transfer product (including security processing) is a compelling passenger proposition. It is vital for the integrity of the Commission's overall determination, that the total revenue flow from transfer passengers is maintained so as to keep all categories of passenger charges in line with the Commission's expectations (i.e. commercial and aeronautical revenue from Origin & Destination, Transfer and CBP passengers).

Summary and conclusions

Aer Lingus considers the Commission's proposal of setting a cap of CPI-4.8% to be consistent with the need to make Dublin Airport an efficient, cost effective airport, helping to promote economic growth in the Irish economy. The combination of recent investment at Dublin Airport and the planned investment envelope in the upcoming determination period, coupled with the service quality targets set by the CAR, mean that Dublin Airport will continue to be a welcoming and attractive choice for passengers. We encourage the Commission to hold firm with these proposals to ensure that Dublin Airport becomes more competitive relative to international benchmarks.

In this response, however, Aer Lingus has highlighted a number of areas of its draft determination which we think the Commission should reconsider. These are:

- **Passenger forecasts:** the assumed income elasticity seems low by the standard of international comparison. **An elasticity of 1.3 is plausible and consistent with evidence from other countries**;
- **Opex:** the existing targets are insufficiently challenging: opex per passenger in 2019 is no lower than it was in 2008. **We believe the Commission's "high" scenario is more realistic, although this itself is only a stepping stone to setting Dublin Airport a realistic medium-term target for opex improvement**;

- **Historic opex:** the appropriate treatment of over-collection of opex (which was not efficiency) for the 2009-14 period. **This gain should be written-out of the RAB**;
- **Depreciation**: the lack of need for, or rationale for, the acceleration of depreciation from post-2019 to the 2014-19 period. **Unless financeability metrics prevent it, we believe any smoothing of X should be done on an NPV-neutral basis within the 2015-19 period.**
- **WACC**: set too high, given the evidence presented. **A WACC of 5.39% is more realistic, given current evidence.**

Finally, Aer Lingus rejects the proposed trigger point for the development of the new northern runway. In our view insufficient effort has been made to explore the scope for more efficient use of the existing runway(s). Achieving performance in terms of ATMs close to that achieved at Gatwick would significantly increase the capacity of the runway and delay the need for any new development by at least five years. We believe that the Commission should cancel the current trigger and reconsider these issues. If necessary any new proposal for a trigger could be reintroduced as an interim determination, although given the likely timing for the new runway being needed, we see no reason why this should occur during the current regulatory period.

Alternative modelling results

Although the Commission has proposed a smoothed reduction of CPI-4.8%, the Commission's own assumptions are consistent with a P_0 reduction in 2015 of **CPI-17.3% in 2015, followed by CPI-1.5% for the next four years**. This achieves a same maximum charge in 2019 of €8.35 per passenger as assumed by the Commission.

Smoothing this profile in an NPV-neutral way (as opposed to bring forward depreciation from the post-2019 period) implies a control of **CPI-7.5%** for the whole period[12]. This is achieved while still applying all the Commission's other cost, revenue or WACC assumptions. This does imply a lower maximum tariff in 2019, €7.24 per passenger, to compensate for holding the tariff higher in the first couple of years.

However, as we have noted, we consider these assumptions may be over-generous to DAA.

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12 This appears to be achieved with virtually no issue related to financeability. All metrics are met in all years, except Debt/EBITDA which fails (at 4.3) in 2015. However this too is trending in the right direction, is below the 4.0 threshold in 2016 and reaches 3.2 by 2019.

Applying all of the adjusted assumptions described above factors, the Commission's model suggests a tariff for **2015 of €7.42, equivalent to a P_0 of CPI-29.5%, followed by an X of -2.0% for the remaining 4 years**. The maximum charge in 2019 would be €6.95 per passenger. Smoothed over the five year period in NPV-neutral terms this amounts to a price control of **CPI-13.3%**.

We note however, that this control could present some difficulties in meeting the Debt/EBITDA financeability metric, in which case we accept that some acceleration of depreciation could be required. We have estimated using the Commission's model that a smoothed control of **CPI-10.5%** is consistent with the more challenging assumptions we have made, and allowing the DAA to meet the financeability metrics for investment grade.

These modelling results are not intended to be definitive, but they indicate the scope available to encourage DAA to achieve greater levels of efficiency, over and above those projected in the draft determination.