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31 July 2013

Mr John Spicer
Commission for Aviation Regulation
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By email and post

Saving consumers €274 million while growing traffic, tourism & jobs

Response to Draft Determination on Airport Charges at Dublin Airport 2015-2019

Dear Mr Spicer,

I refer to CAR's Paper 1/2014 '*Maximum Level of Airport Charges at Dublin Airport 2014 Draft Determination*' of 29 May 2014 ("the Draft Determination"). Ryanair's below submission comprises two sections. The first section contains our general comments on the flawed Irish airport charges regulatory regime. The second section contains our specific comments on the Draft Determination.

A. The Flawed Irish Regulatory Regime

The airport charges regulatory regime in Ireland is entirely ineffective for the following reasons:

1. The CAR (Ireland's non-independent aviation regulator) is appointed by the owner of the DAA monopoly – the Irish Government – and is legally obliged to follow binding directions issued by the Irish Government's Minister of Transport, regardless of how misguided and damaging these directions are. The CAR is therefore incapable of acting independently of the Irish Government, and so any input by Ryanair or other users to the CAR will be ignored and rendered meaningless, as has consistently been the case in the past.

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2. Even the Government established expert Appeal Panel has repeatedly upheld Ryanair's appeals against earlier CAR determinations which allowed the oversized, poorly located and badly designed Terminal 2 and other infrastructure developments and imposed rapacious cost increases to the benefit of the DAA monopoly. However, the CAR simply dismissed these findings and refused to follow the expert Appeal Panel's recommendations

3. The Irish airport regulatory regime had been modelled upon the UK regulated monopoly system, but is deprived of even the basic safeguards of the UK model. This crippled Irish regime has since been further discredited as a result of the UK Competition Commission's March 2009 ruling that the UK regulated airport monopoly regime adversely affected competition and damaged consumer interests. This damning ruling required the break-up of the UK BAA airport monopoly via the forced sale of three of its airports (since completed), yet the flawed Irish system of airport monopoly and non-independent CAR continues unchecked.

B. CAR Paper 1/2014 '*Maximum Level of Airport Charges at Dublin Airport 2014 Draft Determination*'

We make the following comments on the Draft Determination in the expectation that the CAR will ignore our concerns and again impose an uncompetitive and damaging price cap at Dublin Airport. The headings below refer to the sections of the Draft Determination on which we submit comments.

1. Introduction

The Draft Determination fails to mention that Ryanair submitted comments on CAR's 13 July 2013 Issues Paper. Ryanair's response to this Issues Paper, entitled '*Commission Paper 2/2013 – Enabling the DAA monopoly to extort even higher charges from airlines and passengers*', is dated 20 September 2013. Had CAR actually considered Ryanair's concerns and comments contained therein, the Draft Determination would propose a far lower price cap which would serve to stimulate traffic at Dublin Airport.

2. Approach to Regulation

The Paper claims that "*the definition of user for the purposes of making a Determination is broader than just airlines*" and seeks the views of "*the wider airport community*". Airline views

are the best proxy for what passengers require at an airport because the airline market is highly competitive and passenger-responsive, and airline views reflect those of passengers. The UK CAA has confirmed that "*airlines' interests and passengers' interests often coincide, and that passengers' interests are therefore factored into the output of constructive engagement even if they are not physically present during the discussions.*"[1] The fact that Ryanair is the world's largest international airline demonstrates that low fares and operational efficiency are the key considerations for passengers, and that neither airlines nor passengers want "*to pay more for an even better service*". CAR should reflect this in the final determination by lowering the proposed price cap at Dublin for the regulatory period 2015-2019 down to a competitive level.

Without prejudice to the above, if CAR does request the views of "*the wider airport community*", it would be necessary to inform these parties of the costs and impact on airport charges of any proposals. We note for example that the DAA monopoly referred to the views of "*the wider airport community*" when attempting to justify unnecessary capex and gold plating yet admitted that it refused to allow these stakeholders to have sight of the costs and impact on airport charges of these proposals. This proves that the DAA monopoly's "surveys" were flawed, and its "consultation" process was in breach of recital 13 and article 7 of the Airport Charges Directive. CAR must not rely on such opaque methods of "consultation".

Ryanair agrees with CAR that the DAA monopoly should "*assume all the risks that outturns deviate from the numbers assumed in the building-block calculations*". This is inherent in incentive regulation and will encourage the DAA monopoly to outperform the targets set in the Determination which will in turn lead to increased efficiency and benefits to airport users. The Draft Determination is also correct to note that "*passenger numbers is something that DAA has some control over*", and therefore the DAA monopoly should assume this risk even if CAR does not adopt the DAA monopoly's conservative and unambitious traffic forecast.

3. Passenger Forecasts

Ryanair confirmed on numerous occasions throughout the DAA monopoly's "consultation" that passenger traffic volume at Dublin Airport will be dictated by the level of airport charges. Passenger traffic is directly related to the level of airport charges as proven by the dramatic collapse in traffic at Dublin Airport following the substantial price cap increase that CAR rubber-stamped in 2010. Given the reduction in the price cap proposed in the Draft Determination, the current traffic forecast is too conservative. CAR should take account of the lower level of airport charges and apply appropriate demand elasticity assumptions to forecast

[1] CAA Consultation, '*Airport Regulation Lessons learnt from Q5 Price Control Process and Improvements for Q6*', October 2010 (attached as Annex 1)

traffic volumes, and in any event should increase the traffic forecast from the mistakenly low forecast in the Draft Determination. Dublin Airport already has the capacity and infrastructure to handle significantly more passengers, and a higher forecast will in turn lead to a lower price cap which will stimulate traffic further.

Although the regression equation covering the period from Q1 1997 to Q4 2013 is set out in Table 3.2 of the Draft Determination, this fails to include any price effects, and instead relies on the use of dummies relating to different time periods only. Hence, the equation used fails to reflect the extent to which faster growth in the earlier period was driven by Ryanair in driving down prices and increasing growth, or the extent to which growth was suppressed (over and above the effects of the recession) as a consequence of the imposition of the air travel tax and significantly increased charges at Dublin Airport. The regression equation is therefore wrongly specified and fails to account for the causal factors for different rates of demand growth or decline.

The failure to recognise these effects renders the forecasts unreliable and unsuitable as a basis for making a Final Determination. The UK Department for Transport has undertaken detailed modelling of income, cost and other effects on air passenger demand over many years and has derived sophisticated elasticities to GDP and air fares for both short haul and long haul markets. The most recently published UK Aviation Forecasts showed an elasticity of traffic volume to GDP of 1.3, and to air fares of -0.6. If charges at Dublin Airport fall and contribute to a reduction in air fares then growth will be substantially above 1.15 times GDP as used by the CAR, and closer to 1.3 GDP. Assuming growth at 1.3 times GDP only, the expected passenger throughput in 2019 would be at least 24.4 million, some 0.5 mppa higher than projected by the CAR. Assuming no other changes to the costs or revenues projected by the CAR, this alone would reduce the price cap by at least €0.24 by 2019. Should prices fall through adjusting the starting cap downwards, passenger growth would be even faster.

If CAR adopts even the initial correction to the forecasts, which is the correct approach as a minimum in its Final Determination, the passenger forecast will increase as set out in the table below, with the consequent effect on the price cap assuming no other adjustments are made:

Table 1: Impact on price cap of Ryanair's comments regarding traffic forecast							
	2013	*2014*	**2015**	**2016**	**2017**	**2018**	**2019**
Ryanair forecast (m)	*20.2*	*20.7*	21.4	22.1	22.8	23.6	24.4
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	10.03	9.51	9.02	8.55	8.11
Difference (€)	-	-	**0.14**	**0.17**	**0.19**	**0.22**	**0.24**

Note: All adjustments to the price cap are made using the CAR's model

If Ryanair's proposed adjustments to the building blocks are made, the fall in prices would further stimulate passenger growth leading to a virtuous circle of falling prices and growing passenger numbers. Hence, even these forecasts are likely to be conservative.

4. Opex

The Steer Davies Gleave (SDG) report on opex acknowledges the significant savings made recently from re-negotiating contracts for new staff in T2. However, this report also notes that existing ("legacy") staff costs are relatively high in proportion to benchmarks and that the DAA monopoly needs to address this.

SDG's benchmarking analysis also concludes that the DAA monopoly's costs are higher than average, and CAR's own analysis places the DAA monopoly's opex 10% higher than the average of other Ryanair destinations.

Projecting opex forward, SDG identifies "*higher ambition savings*" and "*lower ambition savings*". The basic distinction between these is that the higher ambition savings assume a degree of outsourcing of existing operational functions as a means of addressing the high wage costs of legacy staff, whereas the lower ambition savings assume the achievement of efficiencies without any major renegotiation of legacy staff contracts or outsourcing. Thus, the extent of outsourcing is a key issue. SDG makes assumptions about the potential cost savings from outsourcing, ranging between 30% and 40%. At a minimum, the higher ambition savings option should be the basis for CAR's Final Determination.

Regrettably, the Draft Determination has simply taken a halfway point between SDG's low ambition target and high ambition target in setting its own target. This is a crude assumption and

fails to realistically assess the further savings that could be achieved even if outsourcing is not implemented.

SDG has made erroneous assumptions about increases in wage costs being higher than CPI in various areas. The CPI plus 1.6% allowed for "*higher skilled salaries*" is very high and fails to reflect the fact that the DAA monopoly's salaries are already substantially above the Irish national average and should therefore be reduced by using a CPI minus formula.

SDG's report examines the potential savings in each staff section as follows:

- ***Security:*** there is considerable potential for savings without outsourcing, especially in terms of rostering. SDG identifies that the DAA monopoly currently allows a 26% uplift on the number of rostered staff to allow for leave and sickness, etc. This is extraordinarily high and could be reduced to no more than 10%, so as to incentivise the DAA monopoly to curb its staff and reduce opex. SDG also considers busy day rosters and concludes that 38 fewer staff could be achieved on a busy day. There is an excessive number of staff rostered compared with the requirement identified. In conclusion, SDG notes a reduction of 19 FTEs is achievable without outsourcing and with the "*lower ambition*" target. Nevertheless this is a very modest overall saving given the apparent potential savings that could be achieved from improved rostering. The "*higher ambition*" savings are considerably greater and are obtainable even without outsourcing were the DAA monopoly to move legacy staff on to the new terms and conditions which apply in T2. Manchester Airport achieved savings in the late 1990s through a similar revision of legacy staff terms and conditions and it is therefore reasonable to expect the DAA monopoly to do the same.

- ***Cleaning and Facilities***: there is no rationale as to why some cleaning is undertaken in house and other cleaning is outsourced. The overall function also includes trolley collection, forecourt management, terminal and customer service management functions and others as well. SDG suggests that there is some staff flexibility between these functions in T2 but not in T1. It is possible to achieve similar levels of staff flexibility in T1 with this combination of functions. There are obvious outsourcing opportunities in cleaning and probably further associated efficiencies from (for example) making all cleaning the responsibility of a single provider and improving staff flexibility between tasks.

- ***Campus Services***: SDG has benchmarked staff costs in these areas, but the analysis has completely overlooked any potential for a reduction in staff numbers. The levels of both

airport policing and fire service are excessively high. SDG's report indicates that the DAA monopoly has reduced the number of FTE campus service staff in recent years despite increasing passenger numbers, and the Final Determination should require the DAA monopoly to continue this trend. Other airports in the Ryanair network (e.g. Stansted) have successfully done this, demonstrating that Dublin can do likewise.

- ***Retail Staff***: SDG notes savings are achievable from processing efficiency improvements in T1. However, SDG has applied an elasticity of 0.7 to passenger numbers, implying that if passenger numbers increase by 10% retail staff will increase by 7%. This is inconsistent with the fact, as confirmed by SDG, that "*retail staff costs have declined over the current regulatory period to date, despite the opening of Terminal 2 and associated retail outlets.*" As such there is no reason why retail staff costs should increase and CAR must reflect this in the Final Determination.

It would be wrong, and contrary to CAR's statutory duty "*to facilitate the efficient and economic development and operation of Dublin Airport*", for CAR to set a target for opex savings halfway between SDG's "*low ambition*" and the "*high ambition*" targets. This is especially true as there are additional opex savings that could be achieved even without outsourcing. Given its statutory duties, the CAR must set an opex target that is significantly closer to the "high ambition" target identified by SDG rather than to the "low ambition" target. Indeed if there are realistically achievable opex savings, the CAR is duty bound to set the price cap to incentivise their delivery.

Furthermore, there is prima facie evidence that the DAA monopoly's opex costs are significantly higher than they should be. Firstly, the SDG report notes the inefficiency of DAA monopoly's operations whereby it achieves only 10,400 passengers per staff member while other airports such as Amsterdam, achieve over double this. SDG also notes that the DAA monopoly spent €94 million on "wages and salaries" in 2012. Given that 1,899 FTEs were employed by the DAA monopoly in 2012, this means that the average wage per FTE was €49,500 – significantly higher than the average Irish annual salary of €41,661 as confirmed recently by the Central Statistics Office[2]. Had the DAA monopoly employed staff on the average Irish salary, it would have spent only €79m on "wages and salaries" in 2012 – a saving of €15m. This alone requires CAR to substantially reduce the DAA monopoly's permitted opex in the Final Determination. As such, all salaries should be subject to CPI minus 3% in order to (over time) bring them in line with the national average.

[2] Central Statistics Office, 'Earnings and Labour Costs Annual Data 2012', 19 June 2013

CAR should therefore adopt, as a maximum value of opex, the "high ambition" target to reflect both potential efficiencies and lower wage inflation. This will have the following effect on the price cap, taking Ryanair's higher passenger forecasts into account but making no other adjustments:

Table 2: Impact on price cap of Ryanair's comments regarding opex							
	2013	*2014*	**2015**	**2016**	**2017**	**2018**	**2019**
Ryanair forecast (€m)	-	-	190.7	185.0	181.6	183.1	184.6
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	9.98	9.32	8.75	8.29	7.86
Difference (€)	-	-	**0.19**	**0.36**	**0.46**	**0.48**	**0.49**

Finally, we note that CAR inexplicably ordered SDG to refrain from investigating the DAA monopoly's pension costs, despite the fact that these costs form an integral part of the opex SDG was supposedly charged with investigating. We further note that CAR refused to explain this cover up when so requested by Ryanair on 24 March, 25 February and 5 February 2014.

5. Rolling Incentives

Ryanair does not support the principle of rolling incentives for either commercial revenues or operational costs, which the Draft Determination proposes to introduce/extend the scope of. The current operational cost base of Dublin Airport is excessively high and the substantial investments made in additional commercial/retail facilities are failing to deliver the promised returns.

Whilst, theoretically, rolling incentives might encourage an airport operator to introduce new efficiency savings or revenue enhancing activities earlier than might otherwise be the case, this is only relevant when the regulated entity is already operating at the efficiency frontier or delivering maximum commercial returns. At present, the operation of Dublin Airport is so far away from the efficiency frontier that it is simply wrong for the DAA monopoly to be permitted to retain the benefits for 5 years when the scope for improvements has been evident for decades. Indeed, there is prima facie evidence that the DAA has gamed the system by not declaring to the CAR the level of opex savings which it was expecting to achieve over the last quinquennium. It delayed introducing these and was able to retain part of the benefit under the rolling incentive

scheme. The DAA monopoly should not be rewarded for its inefficiency and the CAR would be failing in its regulatory duty to "*facilitate the efficient and economic development and operation of Dublin Airport*" if it so rewards the DAA monopoly, and adds further incentives for the DAA monopoly to game the system in respect of commercial revenues.

6. Commercial Revenue

The Draft Determination claims that "*commercial revenues at Dublin airport will remain broadly constant on a per-passenger basis for the next five years*". This is illogical and wholly unambitious given that the Draft Determination approves capex of €61.5m (i.e. €6.1m higher than the DAA monopoly stated is necessary) for eight Revenue Projects. If this capex is to be allowed, the Final Determination must assume that the DAA monopoly will generate significantly increased commercial revenue which will in turn lead to lower airport charges through the single till mechanism.

The Draft Determination's own chart 5.1 confirms that Dublin Airport's commercial revenues per passenger are significantly below those of many other European airports. The Draft Determination's target for commercial revenue at Dublin Airport of only €0.10 above the European average demonstrates its lack of ambition, which will harm airport users and hinder traffic growth. CAR should increase the target in order to lower airport charges for airport users via the single till.

Furthermore, Table 5.3 in the Draft Determination lists six "*Revenue Generating Investments*" that CAR has allowed with a corresponding "*Net Contribution 2015-2019*". Given that during its "consultation" process the DAA monopoly refused to provide evidence that these projects are indeed revenue generating, CAR must verify this claim prior to allowing any capex for these projects. Furthermore, CAR should impose penalties if any of these six "investments" fail to achieve the claimed contribution. It is not acceptable for fantasy capex proposals to be included in the RAB if the claimed revenue does not materialise.

In any event, the DAA monopoly does not require commercial property refurbishments to maintain commercial revenues. Airport passengers represent a captive market and as such there is no need to refurbish commercial property every five years as the DAA monopoly claims. Airport retail shops do not compete with high street shops and are in a highly advantageous position due to the high captive footfall. Given the historic investment in retail facilities in both T1 and T2, the recovering economic position and growth in long haul traffic at Dublin, retail revenues should grow with an elasticity to passenger volume of 1.05 over the next quinquennium

CAR should therefore adopt the following commercial revenue forecast which will have the following effect on the price cap taking Ryanair's higher passenger forecasts into account but with no other adjustments:

Table 3: Impact on price cap of Ryanair's comments regarding commercial revenues							
	2013	***2014***	**2015**	**2016**	**2017**	**2018**	**2019**
Ryanair forecast (€m)	-	-	142.4	145.0	148.8	155.6	160.6
CAR price cap proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	10.01	9.47	8.97	8.49	8.04
Difference (€)	-	-	**0.16**	**0.21**	**0.24**	**0.28**	**0.31**

7. Till Exits

The Draft Determination is correct to confirm that "*Proposals to build a Dublin Airport City ["DAC"] are the most likely rationale*" for a change in approach to the regulatory till. Ryanair agrees that as DAC is unrelated to air transport or to the DAA monopoly's regulated airport business, the DAA monopoly must not play any further part in this fantastical Celtic Tiger era project. Additionally, the DAA monopoly has confirmed that it is unable to guarantee that the financing of this project will be ring-fenced. Consequently, CAR should require the DAC land to be sold to a third party developer at market rate, the RAB to be reduced accordingly, and the DAA monopoly to end all interest in this project. This is the only solution that would protect users from the risks associated with DAC.

Please note that Ryanair will shortly submit further comments to CAR in response to the valuation report of the DAC land as prepared by CBRE, and the DAA monopoly's note entitled '*Proposed Till Exit of Commercial Development Sites at Dublin Airport – Note to CAR and Airport Users (02.07.2014)*'. We request that these comments be read in conjunction with the present response.

8. T1X

When first considered in the Interim Review of the 2005 Determination (CP6/2007), users were promised that the costs of T1X would have no effect on prices charged to users – "*Depreciation*

charges and the allowed return on capital for T1X would be capped such that they did not exceed forecast incremental commercial revenues associated with the project. In this way, the project would be charges neutral in keeping with the consultation between the DAA and users." In including the cost of the project within the RAB, the CAR made clear that "*the Commission still intends only to offset the costs of T1X with demonstrated increases in commercial revenues accruing from the project. The project should be charges neutral*" (emphasis added). CAR therefore made a regulatory contract with users that they would not have to pay for the costs of T1X and that it would be paid for through incremental retail revenues.

This approach was confirmed at the time of the last Determination where it was stated that "*For T1X, the Commission has included the capex in the RAB. At the same time, for the purposes of deriving a price cap it has calculated the return on and return of capital allowed to exactly equal the forecast incremental commercial revenues associated with this project. In the absence of any published incremental forecasts for T1X, the Commission has assumed that the project will generate €5m extra each year.*" It was stated that changing the forecast would not alter the price cap as, in effect, the depreciation and return on capital allowed in relation to T1X was capped at the assumed increase in retail revenues included within the price cap calculation.

At that time airport users highlighted to the CAR that this assumption of an increase in retail revenues from T1X was inconsistent with the actual assumption being made by the CAR in calculating the price cap that retail revenues would fall on a per passenger basis over the period. By the time of the Final Determination, the assumed retail revenue per passenger had been reduced still further and the element of this attributed as incremental revenue as a consequence of T1X increased from €3.8 million to €5 million, without evidence or substantiation. This was aimed simply at allowing the DAA monopoly to recover the costs more quickly. This approach is flawed and as it is now clear that T1X has simply not generated any demonstrable increase in retail revenue, it must be excluded from the RAB.

The Draft Determination demonstrates at Chart 5.2 that retail revenues per passenger have in fact continued to fall and, in relation to T1X, hides behind the statement, at paragraph 5.25, that "*our retail forecast included an uplift for T1X; outturns for retail have been broadly in line with this adjusted forecast. However, isolating the effect of T1X on retail revenues proves more difficult over time.*" On this basis, the CAR has simply allowed the undepreciated costs of T1X fully into the RAB to earn a return on and return of capex in the normal way.

This action is inconsistent with the findings of the 2010 Appeal Panel which held that "*If there is no evidence that there are any incremental revenues associated with the capital spend on T1X then it is inappropriate for the Commission to "assume" such incremental revenues to allow the capital expenditure into the RAB when it previously indicated it would only* ***"offset the costs of T1X with demonstrated increases in commercial revenues accruing from the project"****. As to the evidence required to assess the level of any incremental revenues, the position is complicated by the need to establish a counterfactual position, i.e., what would retail revenues have been in the absence of the investment? This is a matter that does not appear to have been satisfactorily addressed in the Determination.*" The CAR was expressly instructed by the Appeal Panel to "*carry out an analysis of the extent of incremental retail revenue attributable to T1X (if any) before allowing the capital expenditure associated with this project into the RAB.*" It is evident that the CAR has once again failed to adequately address the issue.

This breaks the regulatory contract with users that they would not have to pay extra for T1X as it has not been demonstrated that there has been any increase in retail revenue as a consequence of the development. Airport users should not be required to pay the substantial costs of T1X (€55.9 million at 2009) in circumstances where retail revenues per passenger have continued to fall. Clearly, in this context, the substantial investment made in T1X was not economically justified and should not, as Ryanair has always argued, have been allowed into the RAB. Setting the incremental revenues to zero for the next quinquennium, as all the evidence demonstrates to be the actual outcome, would result in a reduction to the opening RAB of €53 million, which would on its own have the effect of reducing the price cap as follows:

Table 4: Impact on price cap of Ryanair's comments regarding T1X

	2013	*2014*	**2015**	**2016**	**2017**	**2018**	**2019**
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	9.92	9.44	8.98	8.55	8.13
Difference (€)	-	-	**0.25**	**0.24**	**0.23**	**0.22**	**0.21**

9. T2 Retail

As with T1X, the evidence demonstrates that the additional floor area provided in T2 has not delivered the additional retail revenues which the DAA monopoly claimed justified the excessively oversized and costly T2 development. In capex consultations prior to the previous Determination, the DAA monopoly told users that there was substantial interest from premium

retailers in T2 and that this would deliver increased retail revenue. This clearly has not happened nor is it expected to happen in the next quinquennium.

The Draft Determination itself notes that *"Nor have we been convinced that the amount of retail space in T2 warrants a step improvement in the retail revenue that DAA is generating."* Whilst noting that on some classifications, the DAA monopoly is earning more per square metre of retail space in T2 than T1, no evidence is provided of the extent of the uplift and the amount of incremental revenues generated. The higher revenues earned in T2 are simply a function of the fact that long haul traffic relocated from T1 to T2. Currently, only 10.3% of the airline seats available from T1 are eligible for full Duty Free purchases whereas the equivalent percentage from T2 is 28.4%. This does not, of itself provide any justification for the excessive area of retail in T2, which was a major factor driving up the overall size of the terminal.

The very fact of the terminal being oversized relative to the annual passenger throughput it was being designed to accommodate has allowed the T2 airlines to bunch their operations into the peak period in an inefficient and uneconomic manner, as evidenced by the pattern of daily departures shown in Figure 49 of the DAA monopoly's Regulatory Proposition. Hence, this confirms that the scale of the T2 development and the allowance of the full amount of its capital costs has contributed to inefficient use of existing infrastructure at Dublin Airport, in particular inefficient use of available capacity in T1. CAR's sanctioning of this inefficiency amounts to a breach of your statutory duty to "*facilitate the efficient and economic development and operation of Dublin Airport*".

In 2010 the Appeal Panel confirmed that the retail areas were oversized and adversely affected airport users: "*In its development of T1X and T2, DAA has chosen to provide a much larger proportion of retail space than similar airports abroad. In the absence of a significant increase in passenger numbers, the existing sales seem likely to be spread over a larger floor area and with greatly increased overheads. This was a decision which involved risk. It may be that in the long run, it will prove to be a commercial success. In the meantime, however, the Panel is of the view that the airlines should not be required to subsidise this overhead from current airport charges.*" In the light of the poor performance by the DAA monopoly in delivering improved retail revenues, CAR must revisit the allowances made for the capital costs associated with additional retail areas in T2 as well as the specific exclusion from the opening RAB of the investment in T1X and in refurbishing the retail areas in T1. Excessive provision for retail was a contributory factor in T2 being over-sized by 40%. The costs associated with the excessive retail areas should be removed from the RAB and the unitised price for T2 adjusted accordingly.

10. Property and ATI Fees

Ryanair supports the Draft Determination's proposed retention of a clawback of any collection by the DAA monopoly of excess Access to Installations (ATI) fees. The process by which ATI fees are regulated, separately to the overall Determination, leaves users exposed to the DAA monopoly setting these fees at too high a level and effectively double charging for use of these assets. Recognising this problem, the Commission proposed in CN2/2008 the use of a claw back mechanism to protect users. There is no case for removing this important safeguard.

11. T2 Trigger and Unitisation

The Draft Determination correctly refuses to follow the DAA monopoly's fantastical claim, in its Regulatory Proposition, that the busy hour throughput actually observed in T2 has an implication for the Box 2 trigger value of 33 mppa. The "evidence" presented by the DAA monopoly demonstrates clearly that the busy hour profile of demand in T2 does not support its original contention as to the relationship between hourly capacity and annual throughput. Instead, the DAA monopoly information clearly shows that the ratio of busy hour to annual passengers using T2 is declining with each year of operation. It is clear that the opening of T2, with its substantial spare capacity, allowed airlines to bunch operations into the peak. This was compounded by the effect of the recession and the curtailment of some operations through the day – peak operations were retained as they generate the highest revenues but more marginal middle of the day operations were cut. Hence, it is not appropriate to draw conclusions on the capacity of the terminal by reference to its operation in the first few years and during a time of constrained demand in a recession, which has resulted in many airports showing peakier profiles of demand that are only now being mitigated as demand begins to pick up again and frequencies in off peak periods are being reinstated. In line with the evidence presented at the time when the scale of the T2 investment was first considered by the CAR in 2007, the busy hour to annual passengers ratio would be expected to decline as the market grows. The Draft Determination is correct to retain CAR's original approach to setting the upper limit on T2 capacity and the Box 2 treatment.

The Draft Determination is also correct in refusing to allow DAA's overspending on T2 into the RAB. The areas of reported overspending related to matters under DAA's control and not to changes in user requirements.

Nevertheless, it remains clear that CAR erred in failing to correctly account for the scale of capacity available in T1 before allowing any of the costs of T2 to enter the RAB. In summary,

whilst the Box 2 threshold is appropriate, the CAR was wrong to allow the costs associated with Box 1 until the full capacity of T1 had been reached as Ryanair has previously made clear.

12. Reconciling 2010-2014 Capital Expenditure

The Draft Determination correctly disallows capex relating to the regulatory period 2010-2014 from the opening RAB where the DAA monopoly failed to deliver certain specified outputs. However, as explained below, the CAR should disallow further amounts in addition to the €11m retail capex noted above.

The Draft Determination states that "*The allowance for Piers and Terminals increases by the amount indicated in the consultation, €4.8m*" for the TSA facility expansion. In the DAA monopoly's 'Response to consultation on TSA Relocation, T2 Dublin Airport' of 4 October 2013, it stated that "*the capex requirement for [the TSA facility expansion] project will be entirely funded from incremental CBP revenues arising from the increased capacity and the funding of the project will not increase overall airport charges.*" Therefore the €4.8m must excluded from the DAA's capex during the regulatory period 2010-2014 and from the opening RAB for 2015-2019. The Draft Determination allows €13m for "*Piers and Terminals*" (including the €4.8m for the TSA facility expansion). However, much of this relates to substantial amounts that were spent on T1 against users' wishes, such as the relocation of T1 security which has led to delays, long queuing times and slow processing of passengers. The CAR must therefore disallow the entire capex for "*Piers and Terminals*".

Furthermore, the Draft Determination erroneously allows €11m for "retail" Expenditure which was originally justified as a revenue enhancing project. However, the DAA monopoly has failed to produce evidence that revenues were actually enhanced. Indeed the Draft Determination's commercial revenues forecast states that commercial revenue per passenger at Dublin Airport will decrease between 2013 and 2014. Given that the DAA monopoly has failed to justify the €11m for "retail" in the regulatory period 2010-2014, it must be excluded from capex during the regulatory period 2010-2014 and from the opening RAB for 2015-2019. At the very least, CAR must remove from the RAB the €11m spent unnecessarily by DAA on refurbishing retail facilities in T1. Disallowing this and the €13m "Piers and Terminals" expenditure, this would have the following effect on the price cap even without other adjustments:

Table 5: Impact on price cap of Ryanair's comments regarding 2010-2014 capex							
	2013	*2014*	**2015**	**2016**	**2017**	**2018**	**2019**
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	9.94	9.47	9.03	8.62	8.22
Difference (€)	-	-	**0.23**	**0.21**	**0.18**	**0.15**	**0.13**

13. Capital Expenditure Allowances 2015-2019

CAR should disallow all of the DAA monopoly's capex proposals for the regulatory period 2015-2019. Other than much lower airport charges and adequate staffing of security points (which does not require additional staff but merely that the archaic work practices in T1 are replaced with those applied in T2), Ryanair has no other requirements at Dublin Airport. Similarly, other Dublin Airport operators cannot have further requirements given the incredible over-capacity following the opening of white elephant T2 in November 2010 and the dramatic traffic collapse since 2007. Dublin Airport now has capacity for at least 35 mppa, but traffic has declined from 23.3mppa in 2007 to 20.2mppa in 2013, with T1 in particular handling 10mppa as opposed to 23.3mppa in 2007.

Throughout the "consultation" process with airport users the DAA monopoly failed to provide any cost breakdown, benchmarking analysis or guarantee that the proposal would be delivered at the lowest cost available. After every "consultation" meeting, the DAA monopoly received voluminous information and clarification requests from airport users due to the absence of same during the "consultation" meetings. Even after these requests from airport users, the DAA monopoly failed to provide business cases or the necessary information. The DAA monopoly's process thus breached Articles 6, 7 and 8 of the Directive which require the airport managing body to provide airlines with information on how and on what basis airport charges are calculated. As such, CAR is obliged to disallow the entirety of the DAA monopoly's capex claims.

Without prejudice to the above position, if CAR does approve of any of the DAA monopoly's capex proposals, CAR must independently (i.e. without placing reliance on the DAA monopoly's CIP) asses the DAA monopoly's business cases for each proposal, verify that the proposal is necessary, that it will improve efficiency at Dublin Airport, and that it will be delivered at the lowest possible cost. We further note that although CAR engaged Ernst & Young ("EY") with

regard to the DAA monopoly's capex proposals, CAR inexplicably prevented EY from scrutinising the rationale for each proposal, and instead limited EY's remit to reviewing only "*the projected cost of Dublin Airport Authority's (DAA) capital expenditure plan, for 2015-2019*". Furthermore, EY's cost analysis is flawed as it proposes to allow higher expenditure than the DAA monopoly is requesting.

In light of the limited information available to Ryanair, and without prejudice to our position that CAR must disallow all of the DAA monopoly's requested capex for reasons set out above, we herewith submit our estimates and comments for the capex proposals:

Table 6: Airfield Maintenance Grouping						
Code	**Project**	**DAA**	**EY**	**CAR**	**RYR**	**Comment**
15.6.001	Runway 16/34 Pavement Rehabilitation	24.3	21.6	21.6	18.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.6.002	Apron Rehabilitation	21.0	22.3	22.3	12.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.6.006	Airfield and Apron Road	1.7	1.7	1.7	1.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.6.055	Airfield Taxiway Rehabilitation	16.0	12.5	12.5	10.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.6.017	Overlay Runway	22.3	29.6	29.6	20.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.9.022	Airfield Pollution Control	20.0	22.5	22.5	15.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.6.004	Airfield Lighting Upgrade (Runway 10/28)	9.1	8.3	8.3	8.3	Based on the limited information available to airport users, the DAA monopoly has overpriced this proposal.
15.6.009	Taxiway AGL Upgrade	3.9	3.6	3.6	2.5	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.4.001	Airfield Vehicles and Equipment	5.7	5.8	5.8	2.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
	Total	**124.0**	**127.8**	**127.8**	**88.8**	

Table 7: Business Development Grouping						
Code	**Project**	**DAA**	**EY**	**CAR**	**RYR**	**Comment**
15.6.047	Apron Development 5G	18.2	16.1	16.1	10.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.

15.7.120	Bus Lounge Facilities	13.3	12.0	12	2.0	Pier D can be used for this project. This would substantially reduce the cost.
15.7.122	Pier 1 Enclosed Gates	1.1	1.2	1.2	0	This should be conducted on a trial basis before any capex is allowed.
15.7.103	Fixed Electrical Ground Power Terminal 1	1.5	1.6	1.6	1.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.6.021	Cargo Gate Redevelopment	1.8	1.7	1.7	0	There is no need for this.
15.6.022	Airport Screening Centre	0.8	0.9	0.9	0.7	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.2.017	Consolidated Staff Car Park	1.5	1.7	1.7	0	There is no need for this proposal.
15.6.007	Airfield Infrastructure for large aircraft	1.5	1.6	0	0	There is no need for this proposal.
15.7.116	Pier 3 Flexibility	15	10.5	0	0	There is no need for this proposal.
15.4.004	Central Search Area – New Technologies	11.6	11.1	0	0	There is no need for this proposal.
15.7.117	Terminal 2 Transfer Facility	21.5	18.7	0	0	There is no need for this proposal.
15.7.121	Terminal 1 Arrivals	8.9	8.8	0	0	There is no need for this proposal.
15.7.119	Terminal 1 Façade	0.7	0.5	0	0	There is no need for this proposal.
15.4.003	Terminal 2 HBS Standard 3	13	12.3	0	0	There is no need for this proposal.
15.6.023	Apron 300R	8.2	7.5	0	0	There is no need for this proposal.
	Total	**118.5**	**106.2**	**35.2**	**13.7**	

Table 8: Information Technology Grouping						
Code	**Project**	**DAA**	**EY**	**CAR**	**RYR**	**Comment**
15.8.008	IT DAA Technology & Lifecycle Man	15.8	15.5	15.5	7.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced and over-specified this proposal.
15.8.009	IT Business Systems Investment	15.6	16.1	16.1	8.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced and over-specified this proposal.
15.5.002	Retail IT	1.6	1.6	1.6	0.5	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced and over-specified this proposal.
15.8.009c	Business Innovation Investment	8.0	1.9	1.9	1.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced and over-specified this proposal.
	Total	**41.0**	**35.1**	**35.1**	**16.5**	

Table 9: Landside and Terminals Maintenance Grouping						
Code	**Project**	**DAA**	**EY**	**CAR**	**RYR**	**Comment**
15.4.002	Light Fleet	2.2	2.5	2.5	1.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.3.004	Car parks maintenance	4.5	2.7	2.7	1.5	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.3.035	External roads	2.0	2.4	2.4	1.0	These roads are relatively new and do not require significant maintenance.
15.3.001	Landside Infrastructure Utilities	4.6	5.0	5.0	2	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.7.102	Terminal 1 Roof Repairs / Upgrades	7.9	7.8	7.8	2.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.4.005	Terminal 1 Baggage Reconciliation System	1.1	1.2	1.2	0	This project should be delivered on a "user pays" basis. Ryanair does not require this project and should therefore not be required to pay for it.
15.4.006	Terminal 1 Critical Equipment Upgrades	6.0	8.0	8.0	4.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.7.104	HVAC & BMS Upgrades	7.4	4.8	4.8	3.5	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
	Total	**35.7**	**34.4**	**34.4**	**15.0**	

Table 10: Revenue Projects Grouping						
Code	**Project**	**DAA**	**EY**	**CAR**	**RYR**	**Comment**
15.5.001	Retail Refurbishments	12.1	17.5	17.5	0	Dublin Airport's retail is relatively new and does not require refurbishment.
15.2.005	Commercial Hangar Infrastructure	0.6	0.9	0.9	0	There is no need for this proposal.
15.2.007	Cargo Terminal Development	2.2	1.7	1.7	0	There is no need for this proposal.
15.2.010	Digital Advertising Projects	1.0	0.6	0.6	0.4	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.2.013	Commercial Property Refurbishments	10.5	10.9	10.9	0	There is no need for this proposal.
15.3.006	Long Term Car Park Resurface	6.7	6.1	6.1	2.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
15.2.009	Consolidated Car Rental Centre	10.0	7.9	7.9	0	There is no need for this proposal.
15.2.006	Completion of Terminal 2 MSCP	12.3	15.8	15.8	7.0	Based on the limited information available to airport users, both the DAA monopoly and EY have overpriced this proposal.
	Total	**55.4**	**61.5**	**61.5**	**9.4**	

Table 11: Other Projects Grouping						
Code	Project	DAA	EY	CAR	RYR	Comment
15.8.001	Minor Projects	10.0	10.8	10.8	10	Based on the limited information available to airport users, it is illogical that EY would propose, and CAR would allow, more capex than the DAA monopoly claimed is required.
15.8.200	Programme Management	3.5	3.1	3.1	0	There is no need for this proposal.
	Total	**13.5**	**14**	**14**	**10**	

Table 12: Cumulative Projects Grouping			
Grouping	**DAA**	**CAR**	**RYR**
Airfield Maintenance Grouping	124.0	127.8	88.8
Business Development Grouping	118.5	35.2	13.7
Information Technology Grouping	41.0	35.1	16.5
Landside and Terminals Maintenance Grouping	35.7	34.4	15.0
Revenue Projects Grouping	55.4	61.5	9.4
Other Projects	13.5	14.0	10.0
Total	**388.1**	**308.0**	**153.4**

Table 13: Projects DAA considered Trigger Projects						
Code	Project	DAA	EY	CAR	RYR	Comment
15.7.111	Pier 2 Segregation	18.0	19.0	0	0	There is no need for this proposal.
15.7.101	Terminal 1 Check-in & Security	38.3	38.1	0	0	As remedial expenditure is required to correct the problems caused by the DAA monopoly's previous misguided expenditure in relocating security against the wishes of airport users, CAR should require the DAA monopoly to undertake this project without including the requested capex in the RAB and without an increase in airport charges.
15.6.012	Extension to Runway	55.0	49.6	0	0	There is no need for this proposal.
15.6.013	Additional line-up points	30.0	27.9	0	0	There is no need for this proposal.
	Fuel Farm	25.0	n/a	0	0	The DAA monopoly should not be involved in this.
	Total	**141.3**	**134.6**	**0**	**0**	

Table 14: Northern Runway Projects – (Trigger 30m)						
Code	**Project**	**DAA**	**EY**	**CAR**	**RYR**	**Comment**
15.6.019	House buy-out (runway related)	4.3	2.3	296.3	50.0	We refer to our comments below on the 'Northern Runway Trigger'. However, based on the limited information available to airport users, both the DAA monopoly and EY have vastly overpriced this proposal. By way of comparison we refer to Dortmund airport which was built (i.e. the terminal, associated building and runway) for under €200m.
15.6.018	Planning and design fees (runway related)	4.0	4.0			
	Northern Runway	236.8	290			
	Total	**245.1**	**296.3**	**296.3**	**50.0**	

If the CAR correctly disallows the entirety of the DAA monopoly's capex proposals, this would on its own reduce the average price cap over the quinquennium by €1.04. Nevertheless, if CAR mistakenly allows any capex, despite the absence of the DAA monopoly's business plans and necessary information as required by the Airport Charges Directive, CAR should allow at most €153.4m. This would have the effect of reducing the average price cap by €0.55, which is consistent with the DAA monopoly's claim that if all capex was allowed, the price cap would not increase, thereby confirming that the price cap should decrease if less than the entire capex is allowed.

Table 15: Impact on price cap of Ryanair's comments regarding 2015-2019 capex							
	2013	***2014***	**2015**	**2016**	**2017**	**2018**	**2019**
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	9.98	9.31	8.69	8.04	7.48
Difference (€)	-	-	**0.19**	**0.37**	**0.52**	**0.69**	**0.87**

14. Northern Runway Trigger

The Draft Determination proposes to allow the full claimed costs of the proposed Northern Runway to enter the RAB if a trigger of 25 mppa is reached. This is in excess of what the DAA monopoly itself sought, which was simply the inclusion of the planning and house purchase costs, albeit at a trigger of 23.5 mppa. The proposed alternative projects of an extension to the existing main runway, 10/28 and additional line up points have correctly been disallowed but the Draft Determination allows in full for the cost of rehabilitating runway 16/34 and resurfacing runway 10/28.

As the airlines made clear at the time of the previous Determination, the use of a passenger related trigger in relation to runway works is inappropriate. There is no direct linkage between passenger volumes and runway capacity. Rather, it would be normal practice to set out a trigger by reference to the proportion of runway slots used over the year as a whole.

Whilst very high utilisation rates, such as the 98%+ seen at Heathrow Airport, can lead to significant delays, Gatwick Airport has been operating at utilisation rates of close to 90% for a number of years and a similar utilisation factor was put forward by BAA previously in relation to the need for a second runway at Stansted.

Based on information supplied in the DAA monopoly's CIP 2015-2019, the average available day time runway capacity at Dublin Airport is 42 movements per hour currently (for a 17.5 hour operational day, excluding any night movements), i.e. approximately 267,500 available runway slots a year (excluding Christmas Day). The runway utilisation rate was thus only 61% in 2013 (based on commercial air transport movements). This is well below the threshold where an additional runway should be contemplated.

The DAA monopoly outlines, within the CIP, a number of measures to increase runway capacity for departing aircraft, which is particularly relevant to the peak morning hour capacity and the number of aircraft which can be based at Dublin Airport. The CIP notes that peak hour departures were 29 in 2013 and that measures are proposed to increase the peak departure capacity to 37, even without the additional line up points to increase the departure rate to 39 movements per hour, which the CAR has disallowed. The identified measures will increase the effective movement rate across all the hours of the day, albeit they will be most effective in those peak hours where departing aircraft movements make up the majority. The effect of these measures will allow an increase in the average hourly movement rate from 42 up to 50 movements per hour on average. The current average hourly runway movement rate on the single runway at Gatwick is over 50 movements per hour and Gatwick does not have the benefit of a cross runway, such as runway 16/34 at Dublin, which allows a higher runway capacity to be achieved than is achievable at Gatwick. The CAR should require the DAA monopoly to produce proposals to better the hourly movement rate achieved at Gatwick through the full use of the capability of runway 16/34.

Just on the basis of the existing improvements to runway capacity put forward by DAA, at 50 movements per hour for a 17.5 hour operational day and a runway utilisation rate of 90% as at

Gatwick, the trigger for a second runway would be of the order of 245,000 annual air transport movements. Gatwick is a relevant comparator as it serves principally short haul scheduled operations with some long haul and charter flights, similar to the traffic profile at Dublin Airport. The timing for the opening of a new runway should, hence, be no earlier than this level of annual movements. Planning and design costs should not be allowed any earlier than 3 years prior to this date in line with DAA's estimate of planning lead times at page 65 of the CIP.

The number of passengers per air transport movement at Dublin grew rapidly in 2009, due to the onset of the recession and airlines withdrawing non-viable flights, from 110 pax per air transport movement to 120 pax per air transport movement in 2010. However, the number of passengers per air transport movement has continued to grow since 2009 at 0.8% per annum on average as airlines have diversified to longer sectors with higher load factors and with the introduction of additional long haul services. Extrapolating GDP and passenger growth beyond 2019 and assuming continuing growth in average passengers per air transport movement, the time when the Northern runway would be needed would be <u>no earlier than around 2030 and 34 mppa</u>, assuming an average number of passengers per air transport movement of 141 (similar to Gatwick in 2013). This would suggest an expenditure trigger being reached in 2027 at 30 million passengers per annum and around 225,000 annual air transport movements.

15. Service Quality Metrics

The Draft Determination correctly refuses to award bonuses to the DAA monopoly for meeting certain service quality standards. The DAA monopoly should not be rewarded for doing its job for which it levies some of the highest airport charges in Europe.

We welcome the revised definition of the security queue length which now finally reflects the actual queue length. Combined with the security queue target of 30 minutes, this will lead to faster processing of passengers and require the DAA monopoly to remedy the inefficiencies which have existed since the DAA monopoly relocated T1 security, against airport users' wishes, to the current location.

16. Cost of Capital

Ryanair notes that the CAR has recommended a Cost of Capital (WACC) of 5.8% rather than the 7.7% requested by DAA. This is still an excessive WACC based on cost of capital estimates for other airports. PwC estimated the WACC for Heathrow, Gatwick and Stansted for the UK CAA in October 2013, as follows:

Heathrow	4.5% to 5.8%
Gatwick	4.8% to 6.2%
Stansted	5.5% to 6.9%

Of the three airports, only Heathrow remains subject to a formal price cap, for which a WACC of 5.35% was adopted in February 2014, close to the mid-point of the range. The equivalent values would have been 5.7% for Gatwick and 6.4% for Stansted based on the UK CAA's best estimates for these airports. Dublin is most similar to Gatwick, given the mix of short haul and long haul operations. Additionally, Dublin's position is likewise similar to Heathrow given their respective monopoly positions. This confirms that a cost of capital of 5.8% is excessive. Furthermore, given that the cost of capital was assessed as being in the order of 6.4% for Stansted, which clearly exhibits a significantly riskier profile than Gatwick as it lacks a broad portfolio of long and short haul traffic, there can be no case for a cost of capital at Dublin approaching anywhere near the level of 7.7% proposed by the DAA monopoly.

We refer to RBB Economics' report '*Cost of Capital for Dublin Airport*' (attached herewith as annex 3) which demonstrates that the WACC proposed in the Draft Determination is excessively high, and should in fact be 5%. The impact of adopting the correct lower value for WACC on the price cap is as follows, even without any other adjustments:

Table 16: Impact on price cap of Ryanair's comments regarding cost of capital							
	2013	***2014***	**2015**	**2016**	**2017**	**2018**	**2019**
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	9.80	9.31	8.85	8.39	7.96
Difference (€)	-	-	**0.37**	**0.37**	**0.36**	**0.38**	**0.39**

17. Return of Capital Allowed (Depreciation) / the Initial Cap

The Paper states that "*the 2013 price cap would have been €1.21 lower*" had it been based on the DAA monopoly's actual costs and revenues, and this would therefore have carried through to the initial 2015 price cap. Rather than immediately rectifying this at the start of the next regulatory period, the Paper claims that Aer Lingus requested "*steady price…across Determinations*" to justify a smoothing of the price cap to achieve a constant 4.8% reduction per annum in real terms over the regulatory period. It is stated at paragraph 6.84 of the Draft Determination that this is achieved by applying an adjustment to the regulatory depreciation allowance so as to achieve a

smooth price path in a manner which, it is claimed, is revenue neutral in NPV terms for users and the DAA monopoly over the regulatory period.

This arbitrary re-profiling of the natural path of the necessary reduction in prices at Dublin airport is unacceptable. The unjustifiably higher prices will hamper traffic growth at Dublin. This will cause damage to consumers, airport users, the DAA monopoly and the Irish economy. Slower demand growth will not be remedied as prices fall later in the quinquennium and the effect of lower demand in the early years will impact on the total volume of passengers over the 5 years as a whole. In itself, this will lead to the cap being set at a higher level than necessary. The CAR should model the effect on demand of adjusting the price profile to reflect the DAA monopoly's actual costs at the start of the quinquennium and the consequential effect on the price cap over the period as a whole taking the higher overall passenger volume into account.

It is all the more unacceptable that CAR should propose re-profiling a price reduction in this way so as to facilitate the DAA monopoly, when CAR refused to similarly protect airport users in the last Determination as it allowed a dramatic increase in the price cap of 21%, from €7.39 to €8.93, in the first year, even before the further increase following the opening of T2. This had a substantial detrimental effect on users and was a major contributor to the traffic collapse at Dublin, yet a different standard is being applied now so as to protect the DAA monopoly.

Given the extent to which users have been overpaying in the current quinquennium, the benefit of the cost savings which the DAA monopoly has made needs to be returned to users at the earliest possible opportunity. To do otherwise would be inconsistent with the CAR's statutory duty "*to protect the reasonable interests of current and prospective users*". CAR should therefore impose the correct price cap reduction of €1.21 in the first year of a regulatory period, in order to return the overcharging to users and reflect the DAA monopoly's actual costs and revenues. There should be no artificial adjustment to the depreciation allowance simply for the purpose of smoothing the price cap. The impact of this change on the price cap is as follows:

Table 17: Impact on price cap of Ryanair's comments regarding depreciation / initial cap

	2013	*2014*	**2015**	**2016**	**2017**	**2018**	**2019**
CAR proposal (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.35
Ryanair (€)	-	-	8.84	8.69	8.48	8.36	8.34
Difference (€)	-	-	**1.33**	**0.99**	**0.73**	**0.41**	**0.01**

18. Price differentiation

The Draft Determination states that it does "*not propose to include any sub-caps in our determination requiring DAA to offer differentiated prices*", yet it bizarrely acknowledges that "*such pricing has merit and [CAR encourages] its use at Dublin airport*".

In previous Determinations, CAR confirmed that it would abide by the user pays principle as a fundamental plank of regulation, consistent with its statutory duty "*to protect the reasonable interests of current and future users of Dublin Airport.*" This alone requires CAR to impose differential pricing upon the DAA monopoly, as the user of particular elements of Dublin Airport's services should naturally be required to pay for those services alone, and not for services it does not use. Furthermore, it is clear that there is a significant difference in service quality between T1 and T2. At the time of the previous Determination, the DAA monopoly proposed substantial capital expenditure on so called 'passenger processing enhancements' in T1 supposedly to raise levels of service to the equivalent standard as T2. This request (rightly not allowed by CAR), confirmed the substantially lower level of service in T1. Furthermore, the Draft Determination has disallowed the DAA monopoly's proposed works to T1 Arrivals and T1 Facade as users confirmed these were not required. It follows that the quality of service will remain lower in T1 than T2, but this must be reflected by lower prices for use of T1 in order to satisfy the economic efficiency test. In correctly disallowing the above capex, CAR must also respond to the clear signal from users that they do not seek or wish to pay for unnecessary "improvements".

In discussions in March 2013 with the (then) UK Competition Commission, the DAA admitted that "*The underlying airport services and facilities provided to the airlines were quite different reflecting the differences in business models and related airline preferences—at a cost-per-passenger level there was probably a 10 per cent difference in terms of the input costs*" between T1 and T2 at Dublin Airport. In fact the actual difference is greater than the 10% the DAA monopoly claimed.

Additionally, in 2009, the Aviation Appeal Panel ruled that there should be price differentiation at Dublin Airport to reflect the different requirements of different types of airlines and taking into account the different quality and service standards in the two terminals. The Panel stated: "*The Panel is of the view that there is considerable merit in Ryanair's submission for differential pricing. Ryanair is a low cost airline. It operates an internet on-line check in system where the passengers print their boarding passes before leaving for the airport. This means that they need neither boarding desks nor check-in kiosks. The end result is that T1 is capable of dealing with*

significantly more passengers than it was a few years ago. This potentially contrasts with the services likely to be required by longer haul passengers at whom T2 is largely aimed."

The Panel went on to say that "*It is precisely because of Dublin Airport's monopoly position that it should strive to cater for different 'airline business models'. DAA's failure thus far to do so has the possible effect that some business models are favoured over others. This in turn implies a potential restriction or distortion of competition in airline markets which the Panel feels should be addressed by the Commission.*" Indeed, the Panel made clear that it would expect differential pricing to be introduced at the time of the opening of T2.

The Panel also found that the DAA monopoly will only introduce differential pricing if it is obliged to do so by CAR, either in the form of different charge caps for each terminal or alternatively by introducing incentives into the price cap to encourage the DAA monopoly to employ differential pricing. As it turned out, the Panel was correct – the CAR failed to impose different price caps for T1 and T2 or otherwise encourage the DAA monopoly to employ differential pricing, and the DAA monopoly has thus far failed to offer differential pricing between T1 and T2.

In the absence of a binding direction from CAR, it is meaningless that the Draft Determination states "*Nevertheless, we continue to believe that such pricing has merit and encourage its use at Dublin Airport. Current and prospective users' needs will be better met if DAA permits users to select different price and service offerings. We do not accept that the airport always has to offer all airlines the same level of service.*" If CAR is truly of this opinion, it must introduce differential pricing between T1 and T2 as it is statutorily mandated to secure "*the efficient and economic development and operation of Dublin Airport*". The T1 price cap should be at least 25% lower than the T2 price cap to reflect differences between the two terminals in terms of service quality and facilities.

C. Summary

The current price cap, which CAR set in 2009, allows the DAA monopoly to impose amongst the highest airport charges in Europe. The DAA monopoly has therefore been permitted to generate significant profits (€26m for DAA's core business in 2013) at the expense of airport users and despite the traffic collapse at Dublin Airport since 2009. The price cap proposed in the Draft Determination remains uncompetitive and will not stimulate traffic growth at Dublin Airport. CAR should adopt the forecast and recommendations as listed above. The cumulative effect of this would be to impose a price cap per the table below:

Table 18: Impact on price cap of all Ryanair's comments							
	2013	*2014*	**2015**	**2016**	**2017**	**2018**	**2019**
CAR price cap (€)	*10.65*	*10.68*	10.17	9.68	9.21	8.77	8.38
Ryanair price cap (€)	-	-	7.66	7.17	6.72	6.40	6.23
Difference (€)	-	-	**2.51**	**2.51**	**2.49**	**2.37**	**2.12**

Compared to the price cap proposed in the Draft Determination, this will save consumers **€274m** over the next quinquennium, thereby stimulating traffic volumes and allowing the efficient and economic development of Dublin Airport in accordance with CAR's statutory duty "*to facilitate the efficient and economic development and operation of Dublin Airport*".

We furthermore call on CAR to introduce separate price caps between T1 and T2 (at a minimum of 25% differential) to reflect service quality and facilities differences between these two terminals, as acknowledged by the DAA monopoly and the expert Appeal Panel.

We look forward to your confirmation that the CAR will proceed as requested above.

Yours sincerely,

Juliusz Komorek
Director of Legal & Regulatory Affairs

Annexes:

1) CAA Consultation, '*Airport Regulation Lessons learnt from Q5 Price Control Process and Improvements for Q6*', October 2010
2) Competition Commission Ryanair/Aer Lingus Merger Inquiry, '*Summary of third party hearing with Dublin Airport Authority held on 26 March 2013*'
3) RBB Economics, '*Cost of Capital for Dublin Airport*', 24 July 2014

Cc: Paschal Donohoe, Minister for Transport, Tourism and Sport
Matthew Baldwin, DG MOVE, European Commission
Hubert de Broca, DG Competition, European Commission

Airport Regulation
Lessons learnt from Q5 Price Control Process and Improvements for Q6

CAA Consultation
October 2010

1. Introduction

Purpose of this document

1.1 In March this year the CAA announced that it was undertaking a review of the process for setting Q5 price controls with a view to assessing, in a forward looking way, the refinements it could make to improve the process for setting price caps for Q6. This document sets out the main points to emerge from this review so far, as informed by views and information given by airports and airlines during formal and informal consultation over the last six months. It also gives the CAA's initial thoughts on the appropriate response to the issues that have been raised.

Structure of this document

1.2 The consultation document is structured into two main parts:

- Chapter 2 briefly summarises the background to the review, the CAA's approach to consultation and the views expressed by interested parties; and
- Chapter 3 contains a discussion of the choices that emerge from these responses, having regard to the legal framework that applies to the sector and the wider context for the Q6 review.

1.3 The CAA is also publishing at the same as this document a report by its consultants Davison Yarrow which contains a fuller account of stakeholders' views.

Views invited and next steps

1.4 The CAA welcomes comments on this document. Any comments should be sent, if possible, by email to airportsreview@caa.co.uk by 19 November. Alternatively, they may be posted to:

Susie Talbot

Economic Regulation Group

4th Floor

CAA House

45-59 Kingsway

London WC2B 6TE

1.5 The CAA expects to make responses available on its website for other interested parties to read. Any confidential material should be clearly marked and included in a separate annex which, subject to further discussion with the author, will not be published.

1.6 The CAA expects to publish a further paper on the Q6 process in early 2011, after considering the responses that it receives to this document. This will also need to deal with the timetable for the reviews, including issues that may arise from the possibility that legislation extant at the beginning of the process (the Airports Act) may have been superseded by the end of it. The CAA has

already begun discussing with stakeholders the complexities that may arise and expects to continue such discussions as prospects for the legislative timetable become clearer.

2. Background

The Q5 reviews

2.1 The most recent reviews of price controls at designated airports began in 2005 and ended with the setting of new five-year price caps for Heathrow and Gatwick airports in early 2008 and for Stansted airport early in 2009.[1] The caps were set by the CAA after it had consulted with a wide range of interested parties, including the airports and their owners, airlines and airline representative groups, passenger representative groups, members of public and the Department for Transport. The CAA was also required by law to seek the recommendations of the Competition Commission before making its decisions and participated in two inquiries of six months' duration during the summers of 2007 and 2008.

The CAA's March 2010 call for evidence

2.2 Since the conclusion of the reviews a range of views have been expressed about the process that the CAA followed and the outcomes the process produced at each airport. The CAA felt it important to carry out a formal assessment of experiences so as to capture as fully as possible the views of stakeholders and to understand where there might be room for improvement in the process for the Q6 reviews, which are due to commence in 2011. It began this assessment at the start of this year.

2.3 As a first stage in the evaluation the CAA wrote to the industry this year with initial thoughts on the scope of its work. The CAA's letter identified six possible areas for consideration:

- the duration of the Q5 reviews;
- the process of airport/airline engagement;
- interaction with the Competition Commission;
- lessons from the legal challenge to the CAA's decision at Gatwick;
- communications; and
- the consumer perspective.

2.4 The CAA also asked stakeholders to comment more generally on aspects of the Q5 process that worked well, aspects that worked less well, and any broader suggestions they had for the Q6 reviews.

Responses

2.5 The CAA received six written responses from BAA, Gatwick Airport, bmi, easyJet, Virgin Atlantic and the Heathrow Airline Operators Committee.

2.6 The responses contained observations both about the Q5 process and the substance of past and future price cap decisions, which the CAA has said

[1] Stansted's Q4 price cap was in 2007 extended by one year, resulting in a 12-month deferral of its Q5 review.

previously would not be examined in this review. On the process side, respondents focused mainly on their perceptions of the strengths and weaknesses of the 'constructive engagement' between airports and airlines during the Q5 review, with comparatively fewer observations about the other matters identified in the CAA's March letter.

Stakeholder interviews

2.7 To understand better the views of the respondents, and to obtain the views of stakeholders that had not submitted written responses to the initial consultation, the CAA set up a series of one-to-one interviews during May, June and July. It engaged an independent consultant from Davison Yarrow to conduct these interviews[2] on the CAA's behalf. A CAA member of staff also participated in the majority of the meetings

2.8 The consultant spoke to a total of 12 organisations that had been involved in the Q5 review, including BAA, Gatwick Airport, the Competition Commission, six airlines and three airline representative groups. In order to learn as much as possible from comparable processes in other sectors, the consultant also spoke to NATS, the Commission for Aviation Regulation in Ireland, Ofgem and ORR.

Key Issues

2.9 The CAA is publishing a report setting out the consultant's findings at the same time as this consultation document. The report identifies a range of issues for the CAA to consider, the vast majority of which relate in some way to the process of airport/airline engagement during the Q5 reviews. By comparison, interviewees raised relatively few points in relation to other aspects of the Q5 process and appeared to be less focused on the CAA's approach in areas like communications and its engagement with consumers. With regard to processes in other sectors, Davison Yarrow found that there were limited lessons other than from the CAA's review of NATS' price controls. This is principally because the CAA has been at the forefront of recognising the value of greater company/customer engagement to the periodic review process.

2.10 Most of the issues raised by stakeholders can be categorised under the six headings set out below. A number of additional points that fall outside of these areas are considered at the end of section 3.

The purpose and output of airport/airline discussions

2.11 Most interviewees saw the outputs from airport/airline discussions very clearly as an input into the CAA's decision-making process. However, a small number of airlines suggested that negotiations between an airport and its customers ought to lead in future to a more general agreement on prices which could preclude any need for the CAA to set a price cap of its own.

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2 The CAA was in attendance at over half of the interviews

The scope of airport/airline discussions

2.12 Airlines that held this view naturally felt that discussions between airports and airlines should be broad, all-encompassing negotiations on the full range of matters that are relevant to the setting of prices. However, even among those that did not see airport/airline engagement in this way, there was an appetite for airlines giving greater scrutiny to cost efficiency and projections of commercial revenues – two areas that were not key areas of focus in airport/airline discussions during the Q5 review.

The CAA's role in airport/airline discussions

2.13 The role of the CAA in the airport/airline discussions was debated at length during the Q5 review itself and continues to be a source of differing perspectives today. Some interviewees felt that the CAA should be a more active participant in the discussions or even act as an arbitrator, particularly when it becomes apparent that agreement among the parties will be difficult to reach and/or when progress on certain key points is a crucial input into subsequent discussions and decisions. Some also felt more generally that it would be helpful for the CAA to be 'in the room' throughout the process as an observer so as to encourage good conduct and to enable the CAA to understand the meeting dynamics behind the information and submissions it receives. Others took a contrary view and argued that the CAA's presence in meetings would fundamentally change behaviours and make it less likely that participants would want to reach agreements.

Process governance, information release and timetable

2.14 All interviewees highlighted how better workstream definition, better project management and clearer rules upfront in relation to issues like representation, the transcripting/minuting of meetings, access to information and timetabling would reduce wasted time and be helpful to both airports and airlines. Of these issues, information disclosure received the most attention, with airlines seeking greater transparency of airports' base business plans, planning assumptions, and the business cases for specific projects.

Interaction between airport/airline discussions and the price control review more generally

2.15 Most stakeholders accepted that airport/airline discussions need to reach some sort of conclusion in order for the CAA to be able to take the outcome of those discussions into account in its setting of price caps. There was, though, a range of views as to what should happen when new information subsequently becomes available or when external events result in a change of circumstances. Some airline stakeholders argued that the ability to make late submissions led to gaming during the Q5 reviews, that the CAA should in future set and adhere to strict deadlines, and that any information not submitted in line with those deadlines should be ruled inadmissible. Others acknowledged that some changes in circumstances are inevitable and that it should be left to the CAA to decide in such situations how best to consult with affected parties.

The role of passengers

2.16 Although not a priority area for interviewees, there were some thoughts from stakeholders on the best ways of engaging with passengers in future periodic reviews, including suggestions about the scope for the CAA to conduct research into passenger preferences and the possibility that passenger representative groups might participate in the constructive engagement process. Some airlines were sceptical of such innovations, arguing that their interests generally align with passengers' interests and that there is a danger of wrongly inferring passenger preferences from the above-mentioned approaches.

3. Questions and Choices

Context

3.1 The Q5 reviews were a considerable undertaking for the industry and included major departures from the approach to previous quinquennial reviews. The CAA believed – and continues to believe – that airlines' knowledge, operational experience, commercial focus and the information that they uncover in their day-to-day interaction with airports, is an immensely valuable input into its decision-making and should be harnessed as much as possible during the periodic review process. It was for this reason that the CAA set up the framework of constructive engagement to extract that input at an early stage of the Q5 reviews.

3.2 Between mid-2004 and mid-2005, the CAA set out in some detail parameters for the process of airport/airline engagement[3].

3.3 The CAA envisaged that for the Q5 airport price control reviews, some of the work usually carried out by the regulator would instead be taken forward by the airports and their airline customers through a process of 'constructive engagement'. The CAA identified a number of workstreams for CE based on areas where airlines could add most value and where it was important to understand airlines' views at an early stage. The CAA review of progress around 2005 was intended to provide it with reasonable assurance that constructive engagement was likely to yield results and therefore enable the CAA to take more informed decisions. In the event that the engagement process did not look likely to proceed as intended, the CAA reserved the right to revert to a more conventional price control process.

3.4 Airports were required to document, in a price control review business plan (PCBP), the nature and substance of agreements reached between the airport and airlines and clearly articulate the way in which the agreements reached met the CAA's Section 39 objectives. The CAA said explicitly it would be looking to see explanation and evidence within the PCBP on how agreements take account of the interests of passengers, as well as small, new entrant (or future) airlines.

3.5 The framework of constructive engagement that the CAA put in place was a significant regulatory innovation for the airports sector, and more generally. There were therefore bound to be lessons for the future; and it should not be surprising that while some aspects worked well others worked less well.

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[3] The CAA's May 2005 document, for example, included detail on:

- the legal context for the CAA's regulation of designated airports and a description of a typical regulatory approach to setting a price control;
- the proposed division of responsibilities between the regulator, on the one hand, and airport/airlines on the other;
- guidance on the process which airport/airline negotiations should follow, and the expected nature of outputs from the negotiation; and
- guidance to the parties in meeting Section 39 of the Airports Act 1986 in the new regulatory approach.

3.6 As far as the CAA is aware, no stakeholder is arguing that the decision to set up a process of airport/airline engagement was the wrong one or that the CAA should revert to an approach more akin to the Q4 review from now onwards. Instead, the views that have been expressed to the CAA over the last six months understandably reveal a number of areas in which improvements can and should be made if the CAA is to obtain the maximum possible value from airport/airline discussions prior to its setting of the Q6 price caps.

3.7 The CAA has itself already recognised this by using lessons from the Q5 process to inform the approach to customer consultation in the ongoing NATS price control review. In particular, the CAA has recognised that giving a clearer mandate to the parties upfront, setting out what is expected of them, increases the likelihood that discussions between the parties will be constructive and will progress either to agreement or to a narrowing of – more clearly articulated - differences between the parties. Most, if not all, stakeholders have welcomed these innovations and indicated that they would like the process for the Q6 reviews to build on the process for the NATS review rather than the now more dated Q5 process.

3.8 The initial thoughts that follow in this Chapter are deliberately confined to these sorts of process issues and do not touch upon the substance of the CAA's Q5 price cap decisions or the issues the CAA will have to confront in setting Q6 price caps. One of the features of the feedback collected from the industry so far is that assessments of the periodic review process may be entangled with views about the judgments that the CAA made at the end of this process. (As is often the case in regulated industries, many customers believe that the Q5 decisions were too generous to the airports; the airports for their part have started to draw the CAA's attention to under-performance on returns pointing in the opposite direction.) There will be opportunities to debate these points further over the next few years and the establishment of a robust and workable process for the Q6 reviews should be taken forward separately from this debate.

3.9 With this context in mind, the remainder of this Chapter works through the issues identified in the summary at the end of Chapter 2. The CAA's working assumption is that decisions in the next round of reviews will be within the legal framework provided by a new Airport Economic Regulation Act, the content of which will be broadly consistent with the announcements made by the government to date. There cannot, however, be complete certainty at this stage as to the content of the Bill or its enactment and it may be that the CAA will need to revisit some aspects of its thinking when the legal and timetabling position becomes clearer. In particular, the removal or otherwise of the mandatory reference to the Competition Commission prior to making its price cap determination has the potential significantly to impact on timescales. It could also be that there are implications for the ways in which and/or the timing with which the CAA's work on alternative forms of regulation feed in due course into the mandate that is put to the parties at individual airports.

However, the airport reviews will begin while the Airports Act remains in force and, in advance of legislative and regulatory change, that will have implications for the scope and conduct of constructive engagement as well as the broader review timetable.

Issues for consideration

Purpose and output of airport/airline discussions

3.10 The suggestion that the CAA should step back from the setting of price caps and give airports and airlines an opportunity to negotiate prices bilaterally extends quite considerably the outcomes that the CAA thought it might be able to achieve when it set up the process of constructive engagement. Although prices are set through commercial negotiation at many UK airports, the designated airports, by definition, will normally enjoy a degree of market power that would act as an obstacle to airlines and airports reaching agreements on price and service quality that are consistent with the CAA's statutory duties towards both airlines and consumers. Such agreements could play a role in future – potentially as part of wider changes to the CAA's regulatory approach – but, as indicated previously, the CAA considers it appropriate to initiate CE against a working assumption that the regulatory approach, and regulatory framework, will remain broadly consistent with the current approach.

3.11 The CAA is empowered by the Airports Act 1986 to impose a price cap on designated airports. The law as it stands requires the CAA to set prices in a way that it considers is best calculated:

- to further the reasonable interests of users of airports within the UK;
- to promote the economic, efficient and profitable operation of such airports;
- to encourage investment in new facilities at airports in such time as to satisfy anticipated demands by the users of such airports; and
- to impose the minimum restrictions that are consistent with the performance by the CAA of its regulatory functions.

3.12 Even if the CAA's duties change following the passage of an Airport Economic Regulation Bill into law, the CAA's statutory functions with respect to the form of economic regulation it applies to airports with market power are likely to remain unchanged. In particular, *the CAA* is likely still to be required regulate in a manner that *it* considers is best calculated to discharge *its* duties.

3.13 While, therefore, the CAA supports, in principle, the reaching of agreements between airports and airlines, it cannot place reliance on such agreements to determine price, service and investment outcomes across the airport. It is for the CAA to judge whether these agreements are in the interests of consumers and consistent with its statutory duties. The CAA does not therefore consider that CE should at this stage be designed with a view to stimulating or relying

upon such agreements. If there is an appetite for such agreements to be explored, supported by changes to the regulatory approach, market circumstances or legislative framework, the CAA could review the scope of CE. The immediate priority, however, will be to commence CE with a clear scope and terms of reference.

3.14 In light of the above, the CAA considers it is important to clarify that the purpose of engagement between airports and airlines is not to agree future prices. Rather, it is to capture the views and preferences of airlines, in particular about the outputs they want from the airports, and to recognise that any agreements reached by the parties are valuable input into a decision that the CAA alone is empowered to take.

3.15 The CAA, in any case, understands that it was only a small number of airlines who thought that the purpose of airport/airline discussions should be to agree prices and that other airlines thought asymmetry of information and their relatively poor bargaining position vis-à-vis the airports were significant barriers to reaching a suitable negotiated price cap. The CAA agrees therefore that the focus prior to the start of the Q6 review should be on making sure that the scope of airport/airline engagement is focused on those aspects of the review where airlines are best placed to inform the calculation of prices and to ensure that process and governance arrangements maximise the likelihood of the parties making genuine progress in those areas.

Scope of airport/airline discussions

3.16 On the question of scope, there appeared to be general agreement that coverage in Q6 should at least encompass what was included in Q5. The key issue that has been raised during the course of this review is whether cost scrutiny and projections of commercial revenue should be areas to which airports and airlines give major focus in their discussions.

3.17 On costs and efficiency, the CAA's thinking at the start of the Q5 reviews was that airport/airline engagement would focus primarily on aspects of the airports' business plans where airlines were best able to contribute, mainly in relation to investment programmes and service quality. The CAA also recognised that airlines would be able to contribute useful insights into the efficiency with which airports carry out their activities and that the benchmarking of costs would be an area that would benefit from joint working, but that the CAA was best placed to bring this evidence together into projections of future opex and capex efficiency. In revisiting this allocation of work and considering whether the scope of airport/airline engagement should expand to give more attention to cost efficiency, the CAA would suggest that it is important to distinguish between:

- the scope for airport/airline discussions to be guided by CAA benchmarking and efficiency work where this can be of assistance in considering trade-offs;
- the importance of ensuring that the consequences, including the implications on opex, of the different choices that there are on

investment and service quality and airlines operations are properly understood; and

- responsibility for efficiency analysis and cost projections moving away from the CAA to airlines.

3.18 On the first two points, the CAA considers that airlines need to be informed if they are to be asked to make choices. Insofar as knowledge of the possible price trends and the opex impacts of those choices are important inputs into the judgements that airlines are being asked to make, they will need to have proper visibility of all relevant cost information. This has implications for the synchronisation of the airport/airline negotiations and the process of information disclosure, which are discussed in subsequent sections below.

3.19 This is not the same as saying that the airlines need to lead the analysis of opex and capex efficiency. When the CAA has consulted previously on the role of airlines in these areas, a number of respondents have expressed concern about their level of expertise and the resources they would need to expend in order to engage effectively with detailed airport cost information. In the recent interviews, there was also acknowledgement that the interests of airports and the interests of airlines run in opposite directions in the area of efficiency, making it difficult to envisage how the parties would be able to make meaningful progress in this area.

3.20 The CAA continues to hold the view that it is best placed to lead the scrutiny of airports' cost base, working as necessary and appropriate with consultants, and that the views of airlines on the scope for future efficiencies are best captured through stakeholder workshops and conventional regulator-led consultation. The CAA would therefore expect to hold one or more workshops for the airports and airlines to discuss opex and capex efficiency within the regulator-led phase of the review, building on the information provided by the airports and the CAA's own investigations and on any points that may emanate from constructive engagement. To go beyond this to greater focus on opex in CE would require a shift in the incentives and dynamics of any discussion, so that the process becomes less of a clash of interests and more of a shared endeavour. The CAA would be open to suggestions on this point.

3.21 On commercial revenues, the CAA considers that it remains best placed to lead the analysis of future income streams and consult on the results of its work as they become available. However, the CAA will naturally take account of any evidence on commercial revenues that emerges from the airport/airline discussions where the parties agree to cover this topic in their discussions.

The CAA's role in airport/airline discussions

3.22 The CAA recognises that some participants in the Q5 process of constructive engagement were disappointed that discussions did not result in a broader range of agreements on key points. The suggestion that the CAA should intervene more actively in the Q6 reviews to promote good conduct and broker consensus may flow from this. It may also reflect the view of some

participants that constructive engagement is a negotiation rather than an input into the CAA-led review.

3.23 The CAA argued that its direct involvement, as a matter of routine, in airport/airline discussions would alter the dynamics of the discussion adversely and result in substantially less useful industry input into the CAA's work. It could also expose the CAA to the risk of its interventions being seen to pre-judge its final price control decision many months before that decision is actually made. It has therefore resisted suggestions that it should act as a facilitator, negotiator or chair, both during the Q5 airport reviews and during the ongoing NATS price control review.

3.24 The CAA continues to hold the view that the constructive engagement phase of a price cap review is fundamentally different in nature from the regulator-led phase of the review. Specifically, airport/airline engagement is intended to uncover the sorts of mutually beneficial agreements and trade-offs that emerge as a matter of course in the commercial negotiations that take place at most other UK airports. To the extent that such agreements are possible, at least in some areas, even at airports with significant market power, it follows that constructive engagement should not be another form of regulator-led consultation, but something different and distinct from the regulator-led process that ultimately has to be a feature of price setting at the designated airports.

3.25 The CAA therefore considers that it is important to tread cautiously before deciding to change significantly the CAA's role in airport/airline dialogue during the Q6 reviews. In particular, the CAA would not wish airport/airline discussions to be regulator-led from the very outset of the process.

3.26 This then raises the question of what should happen when discussions reach an impasse or when it becomes apparent that agreement on even a subset of the issues is unlikely to be forthcoming. The default position has been that the parties record their different positions, end discussion and leave it to the CAA to pick up the relevant issues in the regulator-led phase of the review. The CAA has always regarded the clear identification of such differences as itself a valuable contribution to its decision making. However, the improvements that the CAA intends to make to process governance, summarised in the next section below, should assist in reducing the scope of any disagreements and enhance the prospects of consensus.

3.27 It is against that background that the CAA needs to assess whether stepping into the process to unblock a potential impasse in discussions would yield benefits. In particular, the risks that the CAA has identified previously in relation to changes in the dynamics of discussion and a risk of pre-judging future decisions would need to be considered. It could be, for example, that the mere knowledge that the CAA is willing and able to step into the proceedings alters one or both parties' willingness to discuss potential trade-offs. The presence of the CAA in some workstreams (i.e. where the parties have made no progress themselves) but not in others (i.e. where the

prospects of reaching agreements are more promising) could also be confusing and unhelpful.

3.28 The case for change in the Q6 reviews is therefore not yet made. However, before taking a decision on how it should proceed, the CAA would like to understand better how stakeholders view the likely advantages of CAA intervention in stalled discussions in a 'step in and step out' role on specific issues versus the likely disadvantages adduced above.

Process governance, information release and timetable

3.29 The observations made at the start of this Chapter about the innovative and experimental nature of constructive engagement are undoubtedly a factor that is relevant to the concerns that have been expressed about process governance during the Q5 reviews. The CAA recognises that more can and should be done to establish the rules of engagement at the very outset of the Q6 process and expects to be much clearer about the parties' obligations and responsibilities prior to the start of the review.

3.30 As noted earlier, the CAA understands that the refinements it made in this area during the NATS price control review are generally welcomed by the industry. It therefore expects that its mandate to airports and airlines next year will build from the mandate given to NATS and airlines last year. Among other things, this will mean articulating:

- the legal context for the review;
- the scope of airport activities under review and the strategic questions for discussion;
- who should chair the process;
- the respective roles and responsibilities of both sides, including the behaviours expected of them during discussions and the importance of appropriately senior representation;
- the obligations of the airports to supply airlines with timely and comprehensive information, including the provision of a fully supported base case business plan at the outset of the discussions;
- the role of the CAA; and
- a clear timetable for the parties to adhere to in their discussions.

3.31 This section of the mandate dealing with information provision, in particular, will offer an opportunity to deal with concerns expressed by airlines about information flow from the airports and how this might hamper effective engagement. There will also need to be provisions for airline information to airports where this may assist discussion.

3.32 The CAA would also expect to ask the parties to:

- develop and adhere to a written code of conduct[4];
- produce a project plan/schedule of meetings specifying clearly the objectives and areas of discussion;
- supply the CAA with all papers, submission and data shared by the parties;
- provide the CAA with minutes of meetings; and
- conduct a mid-term assessment of progress and prospects for agreement.

3.33 The evidence from the NATS review is that this was a platform which promoted constructive working and gave the parties a good chance of reaching agreements on the issues being discussed. The CAA would welcome the views of stakeholders on any further refinements in the context of the Q6 reviews.

Interaction between airport/airline discussions and the price control review more generally

3.34 The CAA recognises that the sequential nature of the periodic review process can cause difficulties when there is a material change in circumstances after the airport/airline engagement phase of the review has concluded. The CAA does not agree, however, that it should automatically rule information to be inadmissible if it has not previously been submitted by the airports to the airlines. The law requires the CAA to set a price cap best calculated to discharge its duties under the Airports Act and deliberately to ignore relevant information when making a decision would not be consistent with this obligation or likely comparable obligation under successor legislation.

3.35 The CAA's view is that the concerns of airlines can be addressed in part by ensuring that the scope for changes to emerge after the constructive engagement phase of the review is kept to a minimum and in part by ensuring that there is a process of consultation when external events alter the facts and evidence on which the parties have previously relied.

3.36 On the former, the CAA would expect the changes it is proposing to make to its mandate to result in a better flow of information to airlines during their discussions with the airports. Given this, the CAA would be unsympathetic to subsequent submissions by the airports which seek to bring in information which was previously withheld from these discussions. The CAA also recognises that it needs to coordinate the timetable for regulator-led work in areas such as benchmarking with the project plan for airport/airline engagement so as to ensure that the parties receive early indications as to the Q6 cost base when making their judgements.

3.37 On the latter, the CAA is able to consult with airlines in a variety of ways in the later stages of its periodic review. Depending on the nature of the change in circumstances, the CAA might wish to solicit airline views through bilateral

[4] For the NATS CP3 review the CAA included this aspect within the mandate for CE.

meetings, stakeholder workshops or through written consultation documents. The CAA can also restart formal airport/airline discussions on particular matters if this is the most expedient way of capturing industry input.

3.38 The CAA's intention would always be to ensure that parties affected by the CAA's decision are treated fairly and have a reasonable opportunity to make their views known. Given this, the CAA does not believe it can or should be more prescriptive at this stage about how it would handle a material change in circumstances, but that it should allow itself flexibility to respond according to the situation it faces.

Passengers

3.39 It will clearly be important that the CAA both understands passenger requirements and has the appropriate channels or fora to enable ideas or propositions to be tested. Precisely how this is best done will be returned to next year once the government's intentions as regards passenger representation in the industry have become clearer. In particular, it will be important to ensure that airport specific passenger views can be taken into account.

3.40 The CAA's view at this stage is that while airports and airlines must demonstrate how passenger interests are taken into account, it would not be appropriate to bring passengers or passenger representative groups directly into the framework of constructive engagement. The CAA sees this process as being first and foremost a commercial discussion between the airports and their immediate customers akin to the negotiations that occur in other UK airports; it would be odd to involve passengers in these specific discussions when they do not themselves have a commercial relationship with the airport.

3.41 There is nevertheless merit in reflecting on, andimproving, the ways in which passenger interests can be better taken into account in the periodic review process more generally. The CAA recognises that the revealed preferences and behaviours of individuals provide the most powerful evidence of what it is that that passengers want from airports, that airlines' interests and passengers' interests often coincide, and that passengers' interests are therefore factored into the output of constructive engagement even if they are not physically present during the discussions. Any engagement with passengers should ideally complement this evidence rather than displace it from the CAA's decision making.

3.42 To this end, the CAA will consider in greater detail how to consult effectively with passengers and passenger representative groups during the course of its periodic reviews. It may be, for example, that there are ways of obtaining feedback from this stakeholder group other than through their written responses to CAA documents, for example through standing challenge, or occasional focus, groups.

3.43 The CAA already conducts survey work with passengers and there may also on occasion be merit in using such processes to compile information on

passenger preferences. The CAA might also be able to make use of the survey work already undertaken by airports and airlines. It will be important to avoid duplication and associated additional costs to industry.

Other points

3.44 There were a relatively small number of points made by stakeholders that are not addressed explicitly in the preceding discussion.

- Duration and intensity of the Q6 review – the Q6 review will begin slightly later in the regulatory cycle than the Q5 review and, dependent upon the content and passage of the Airport Economic Regulation, may not involve a mandatory reference to the Competition Commission. This should make the Q6 review more like the regulatory reviews in other sectors in duration and intensity and address to some degree the concerns that some interviewees expressed about the Q5 review;
- Interaction with the Competition Commission – with the same qualifications as above, the removal of the mandatory reference to the Competition Commission would address concerns about duplication of work over the course of the review; and
- Bilateral meetings between the CAA and airports – the CAA is content that bilateral meetings between the CAA and individual parties, whether airports, airlines, passengers or government, are a necessary and appropriate part of the periodic review process. Consistent with practice in other regulated sectors, it would not expect to publish the minutes of these meetings.

Views invited

3.45 The CAA would welcome the views of stakeholders on all of the issues discussed in this Chapter. The CAA would also like to understand if there are any other points not covered in this document or the accompanying Davison Yarrow report which it should be addressing now prior to the commencement of the Q6 price cap reviews.

3.46 While the issues in this document remain open to consultation it is important that stakeholders can plan ahead. It is therefore the CAA's current intention that the process of airport/airline engagement within the Q6 review for Heathrow and Gatwick will start some time around the end of the first quarter of 2011 (Stansted's review is a year later). It is also the CAA's intention that this would be initiated by airport base business plans. The CAA expects to publish further thinking on the Q6 process, including timetabling, at around the turn of the year ahead of issuing a formal mandate for constructive engagement.

RYANAIR/AER LINGUS MERGER INQUIRY

Summary of third party hearing with Dublin Airport Authority held on 26 March 2013

Competition between Ryanair and Aer Lingus

1. Dublin Airport Authority (DAA) considered Ryanair and Aer Lingus to be each other's closest competitor and very actively competing with each other in the short-haul market, although the two airlines did not operate the same model, in the sense that Ryanair was a European network-wide carrier with many bases across Europe. Ryanair and Aer Lingus accounted for approaching 90 per cent of the market between the UK and the Republic of Ireland (RoI) and operated a number of overlapping routes.

2. Since 2007, which had seen a peak of activity at the airport, there had been a recession in the Irish market which had intensified competition between Ryanair and Aer Lingus—while total capacity had fallen, directly overlapping capacity had increased. In addition, Aer Lingus Regional—previously Aer Arann—had come within the Aer Lingus umbrella as a franchised operation and was operating essentially as a component of the Aer Lingus network. It said that other airlines, such as BA and Air France, had relatively small market shares in the RoI–UK market.

3. Specifically, the Ryanair/Aer Lingus combined share between the UK and the RoI had risen from 86 per cent in 2007 to 90 per cent in 2012. The number of overlapping routes had remained constant over that period at six routes. The number of overlapping routes to the UK in which Ryanair and Aer Lingus had a combined market share of 100 per cent had increased from three in 2007 to five in 2012 and the proportion of total market capacity accounted for by the overlapping routes had increased from three-quarters of the market in 2007 to 85 per cent in 2012.

4. One factor driving this trend was the recession, which had caused overall capacity to decrease, with other airlines dropping more capacity than Aer Lingus or Ryanair.

5. Both Ryanair and Aer Lingus had shown network-wide increases in their yields in double digit percentages over the last two or three years.

6. DAA said that the taxes and charges published by the airlines on selected routes ex-Dublin did not reflect the actual taxes and charges they incurred at Dublin Airport. Based on charges observed at various dates it appeared that the airlines were earning margins of between 30 and 50 per cent on what were presented to customers as taxes and charges.

7. It had also observed a matching pattern in the taxes and charges imposed by Ryanair and Aer Lingus, whereby often one of the airlines would increase its charges and the other would then match it. At times the airlines had charged exactly the same rate, although this was not always the case. For example, published charges had dropped markedly after a reduction in government tax, but had subsequently increased again. It was not always the same airline that went first. The pattern demonstrated the possibility of cooperation between the airlines, although this was not necessarily evidence that Aer Lingus and Ryanair were coordinating.

8. The underlying airport services and facilities provided to the airlines were quite different reflecting the differences in business models and related airline

preferences—at a cost-per-passenger level there was probably a 10 per cent difference in terms of the input costs.

Entry

9. DAA said that the current runway situation was one of constrained capacity in the first wave of departures. Over the course of the day, there was generally more capacity available. Delay criteria in particular (90 seconds between departing aircraft) constrained the runway as well as a constrained number of flight paths and a lot of aircraft going in the same direction. DAA was currently exploring how the capacity of the runway could be increased, with regard to, for example, access and exit routes to the runway and aircraft queuing.

10. Against the backdrop of a fairly significant drop in demand over the last few years, DAA was evaluating its forward strategy. It had planning permission for a second parallel runway, which would alleviate the runway constraint. However, it wanted to examine thoroughly the scope to obtain the maximum use of existing capacity before proceeding. The current Irish government would be cautious about building new assets.

11. DAA generally would be keen to have more connectivity and more infrastructure at the airport as this enhanced the potential for new entry and the potential for delivery of improved choice and value for consumers. But neither of the incumbent airlines—Ryanair or Aer Lingus—were supportive of a further runway in the near future. The economic regulation of the airport was carried out by the Irish equivalent of the CAA and that authority would take account of the airlines' views in examining proposals for new infrastructure.

12. Ryanair's treatment of attempts at new market entry was fearsome. It had recently targeted a new entrant on a route in terms of capacity scheduling, choice of routes and very aggressive pricing. Its competition had been very direct (ie on the same day at more or less the same time). This competitor was now exiting these routes. Ryanair also had greater leverage than many local competitors in its ability to take on the same competitor across all of Europe.

13. The RoI was a fairly small market and was fortunate to have two Irish airlines which were financially strong and had performed well over the last number of years. It was important that the airlines had a base in Dublin, partly because the time difference with Europe meant that it was vital for business travellers to be able to get out of Dublin in the morning. Aircraft wanted to have the maximum number of rotations during the day but the morning peak was the limiting factor. Stand capacity was also a constraining factor.

14. From an airline's point of view, the most profitable customers were business customers. This was why morning and evening departures were critical. Business customers were the most high-yield-generating customer base.

Capacity constraints

15. DAA would be re-evaluating past expansion plans to expand Piers A and B at Terminal 1, in the context of discussions that were about to start on capital spend for the years 2015–2019.

16. With regard to the allocation of stands between various airlines, DAA had a set of stand allocation rules giving priority on the basis of objective criteria which were

consulted upon with users. In addition the allocation of stands had to take account of details such as the fact that not all stands could accommodate all aircraft sizes and not all stands were served by air bridges.

17. There were difficulties about providing sufficient stand capacity for early morning flights. Airlines needed to be encouraged to show flexibility in this situation, eg on departure times. Coordination with the slot coordinator, who was independent, was also essential. 'Grandfathering' of slots was an accepted provision within slot coordination. EU slot legislation contained rules about the definitions of new entrants and the percentages of new slots that could be allocated to them.

18. The result of these constraints was that it would be very difficult for a new entrant to obtain sufficient slots at appropriate times to enable it to make a bid for a large share of the RoI–UK market.

Consolidation in the airline industry

19. DAA said that in some cases consolidation in the airline sector had been due to the very challenging market conditions in a number of economies, which had meant that many airlines had found it difficult to make a solid return on a consistent basis. Some ailing carriers had been taken over.

20. Two diverging models had emerged in the European market. The first model was that of the large carriers, which were primarily focused on long-haul business. Examples were BA, Lufthansa, Air France/KLM. These airlines saw their future and their profitability in carrying passengers long haul, consolidating their operations in one or two locations and feeding those locations from multiple points.

21. The second model was that of the low-cost carrier, which covered the intra-European market.

22. The size of an airline's operations at its bases would allow it to achieve economies to scale. Aer Lingus had managed to compete effectively despite being small because of its significant base in the RoI.

23. In addition, larger airlines also had a significant amount of buyer power. For example, they were better resourced to make their voices heard by slot coordinators and regulators.

24. There were also airline operating committees operating at local level and the larger airlines tended to be very vociferous in these. For example, airlines had threatened to reduce services if their requirements were not delivered.

Ryanair's shareholding in Aer Lingus

25. DAA could not see direct effects of Ryanair's behaviour as a shareholder. It was aware, for example, of public calls for extraordinary general meetings. However, as a supplier, DAA dealt with the aftermath of shareholders' decisions, but it did not have visibility of the interaction between the shareholders leading up to that decision.

26. [✂]

Cost of Capital for Dublin Airport

RBB Economics, 24 July 2014

1. Introduction

On 29 May 2014, the Commission for Aviation Regulation ("the Commission") published its Draft Determination for the Maximum Level of Airport Charges at Dublin Airport from 1 January 2015. This note, prepared by RBB Economics at the request of Ryanair, comments on one aspect of the Draft Determination: the cost of capital.

The Commission proposes a real pre-tax weighted average cost of capital ("WACC") of 5.8%. This figure is 120 basis points below the rate of 7.0% used in 2009. However, it is near the top of the range of estimates that the Commission considers reasonable today.

In this note, we show that the WACC that the Commission has assumed is almost certainly overly high. In Section 2, we set out the context for the Commission's analysis. Section 3 summarises the Commission's proposals and Section 4 contains our assessment of these. Section 5 concludes.

2. Context

When setting the price cap, the Commission is required to have regard to three statutory objectives:

- the efficient and economic development of Dublin Airport;

- the ability of the Dublin Airport Authority ("DAA") to operate in a financially viable manner; and
- the protection of the interests of users and potential users of the airport.

These objectives are to some extent aligned: it is in the interests of users that Dublin Airport develops efficiently and is able to operate in a financially viable manner. However, there also exists an inherent degree of tension between these objectives.

When it comes to setting the appropriate value for the cost of capital, this tension is especially apparent. An overly low cost of capital will not allow DAA to operate in a financially viable manner and will not be in the long-term interest of users if this results in efficient airport investments not being made. But whilst an overly high capital will allow DAA to operate in a financially viable manner, the resulting overly high airport charges will not be in the interests of users or potential users and will hinder efficient development of Dublin Airport.

Consequently, it is often necessary to strike an appropriate balance between these three objectives. This applies to the cost of capital as well as to other regulatory parameters.

A specific consideration in the context of the cost of capital is that the cost of capital is subject to a degree of uncertainty. Estimating the cost of capital requires making a number of assumptions and there is often disagreement between experts as to the appropriate assumptions to make. Reflecting this uncertainty and given the need to ensure that the regulated entity is able to operate in a financially sustainable manner, regulators have in the past often preferred to set a rate that is more likely to err on the high side than on the low side. This has also been the approach of the Commission in previous Determinations. In doing so, regulators effectively provide the regulated company with a "safety net".

As explained below, however, the rate of 5.8% that the Commission proposed to set for the period starting 1 January 2015 is almost certainly excessively conservative and not consistent with the Commission's duty to protect the interests of users at Dublin Airport. We believe that a lower rate would better protect the interest of users while still allowing DAA to operate in a financially viable manner and ensure the efficient development of Dublin Airport.

3. The CAR's proposals

In the Draft Determination, the Commission presents the results of its analysis suggesting that the real pre-tax WACC is likely to lie within a range of 3.8 to 5.9%. Within this range, the Commission adopts a point estimate of 5.8%, almost at the top of the range.

Leaving the assumed tax rate aside, this estimate is based on a total of five assumptions, discussed in turn in the Draft Determination. The assumption and the point estimate chosen in each case are summarised in Table 1 below.

Table 1: Assumptions underlying CAR's cost of capital estimate

	Low	High	Point
Risk-free rate	0	1.5	1.5
Equity risk premium	4.5	5.0	5.0
Asset beta	0.5	0.6	0.6
Gearing	0.5	0.6	0.5
Cost of debt	2.5	3.0	3.0

As the table shows, the Commission has in almost all cases picked an estimate at the very top of the identified range. The assumption on gearing represents the only exception. However, the impact of this is small: the gearing assumption of 0.5 rather than 0.6 only acts to reduce the WACC from 5.9% (the value that would have resulted from a gearing assumption of 0.6) to 5.8%.

The WACC of 5.8% represents a reduction of 120 basis points from the value of 7.0% used in the previous Determination. The Commission claims that this entirely results from changes in the empirical evidence rather than a change in approach on their part.

4. Assessment

While the Commission's approach can be criticised on a number of grounds, we focus our discussion in the present note on the two most pertinent points. These are the following:

- the assumed cost of debt; and
- the size of the "safety net".

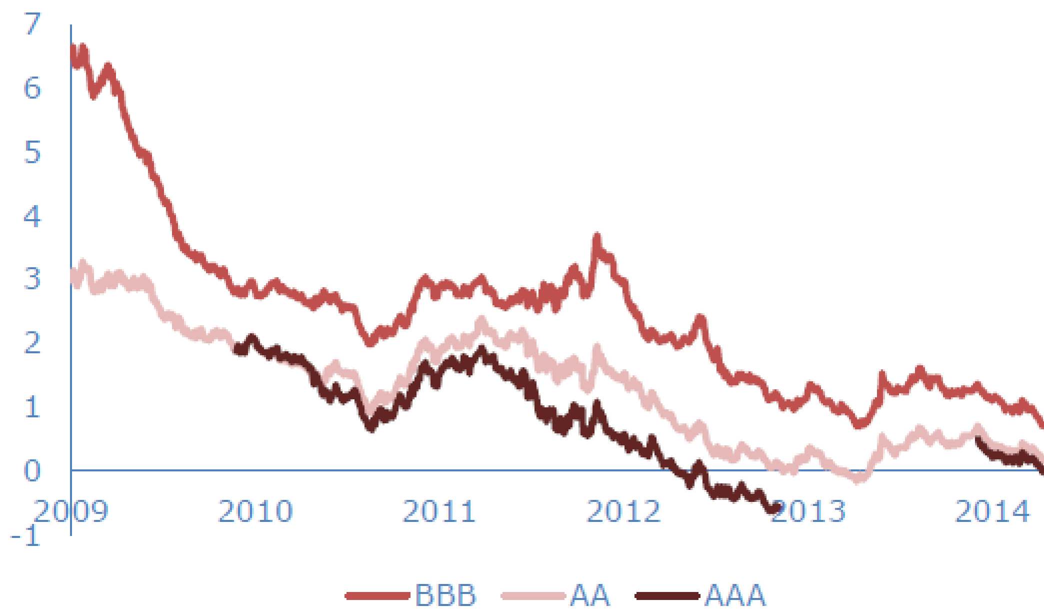
We discuss these points in turn below.

4.1. The assumed cost of debt

The Commission has used an assumed real cost of debt of between 2.5% and 3%. As indicated in the Draft Determination, this estimate has been derived with reference to the cost of issuing new debt for BBB-rated companies, consistent with the Commission's approach in the past.

The Commission supports its assumption by data on the real yield of corporate non-financial bonds with a target rating of at least BBB. We replicate Chart 6.10 in the Draft Determination as Figure 1 below.

Figure 1: Corporate Non-Financial Real BBB Eurobond Yields (%), 7-10 Year Maturity



Source: replicated from the Draft Determination, p. 64

As the figure shows, yields on BBB-rated bonds have fallen dramatically in recent years. At the time of the previous Determination, real yields were in the order of 3% to 4%.[1] Currently, however, as noted in the Draft Determination, they fluctuate around 1%. The Commission goes on to state, based on a comparison of *nominal* yields, that Irish corporate bonds do not give rise to a significant premium for a given rating.

The Commission then indicates that in its view, market evidence suggests that a real cost of debt for Dublin Airport in the range of 2.5% to 3% is appropriate. Ultimately, the Commission adopts a point estimate of 3%.

The basis for the Commission's view is entirely unclear and the Commission does not introduce any further evidence. The only market evidence that the Draft Determination cites regarding real yields on European BBB bonds suggests, as noted above, that these currently fluctuate around 1%.

At this point, it is instructive to draw a comparison with the 2009 Determination. In that Determination, the Commission assumed a real cost of debt of 4.1%.[2] As the above figure shows, that assumption was in line with the yield on BBB Eurobonds at the time. The new assumption of 3.0% implies a reduction in the cost of debt of 110 basis points. However, as the above figure clearly shows, the actual fall in yields has been far more significant than that.

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[1] The 2009 Determination (p. 126) shows *nominal* yields at the time at between 4 and 5%.

[2] See the 2009 Determination, p. 123.

It is of course possible that, in deriving its assumption, the Commission has been guided by other considerations. However, the Draft Determination does not indicate what these other considerations might be. In any event, to the extent other considerations have played a role, the Commission would in that case be deviating from its past approach, contrary to its stated position.

Based on the above, the Commission appears to have substantially overestimated the appropriate real cost of new debt for Dublin Airport. The evidence that market yields currently fluctuate around 1%, and have been below 2% for a period of two years now, suggests that a range of 1% to 2% would be more appropriate.

4.2. The size of the "safety net"

As noted above, the Commission has opted for a point estimate of the WACC almost at the top of the range that the Commission has identified, thereby providing DAA with a "safety net". It has also done so in the past. However, the safety net that the Commission has assumed is much greater than before and almost certainly overly high.

In this context, it is useful to revisit the process leading up to the 2009 Determination. In the Draft Determination, the Commission proposed a range of 6.1% to 7.1%, ultimately adopting a point estimate of 7.0%. As noted above, the assumption near the top of the range reflected the uncertainty inherent in estimating the WACC in combination with the need to ensure that Dublin Airport would be able to continue in a financially viable manner.

It is possible to calculate the maximum size of the "safety net" by calculating the difference between the top and the bottom of the range identified by the Commission. In the simple example below, we assume, for ease of exposition, the size of the RAB to be equal to €1bn. We then proceed as follows:

- first, we assume the true WACC to be equal to the bottom of the range identified by the Commission (6.1%), and calculate the total cost of capital in that case;
- second, we calculate the actual return on capital that Dublin Airport is allowed to earn given the Commission's point estimate of 7.0%; and
- third, we calculate the size of the safety net both in absolute terms and in percentage terms.

The results of this calculation are given in Table 2 below.

Table 2: Maximum safety net in 2009 Determination

Assumed RAB, €m	1000
Total cost of capital if WACC = 6.1% (bottom of range), €m	61
Allowed return on capital given WACC = 7.0% (point estimate), €m	70
Maximum safety net, €m	9
Maximum safety net, %	15%

As the table shows, the size of the safety net that Dublin Airport was allowed in the 2009 Determination was no higher than €9m (given our notional RAB assumption of €1bn), or 15%. That is, the maximum difference between the true cost of capital and the allowed return on capital, expressed in absolute terms, would not be higher than 15%.

We now replicate this calculation for the Draft Determination. As noted above, the Commission has assumed a range between 3.8 and 5.9% and has adopted a point estimate of 5.8%. Table 3 below calculates the maximum size of the safety net under the Commission's proposed approach.

Table 3: Maximum safety net in 2014 Draft Determination

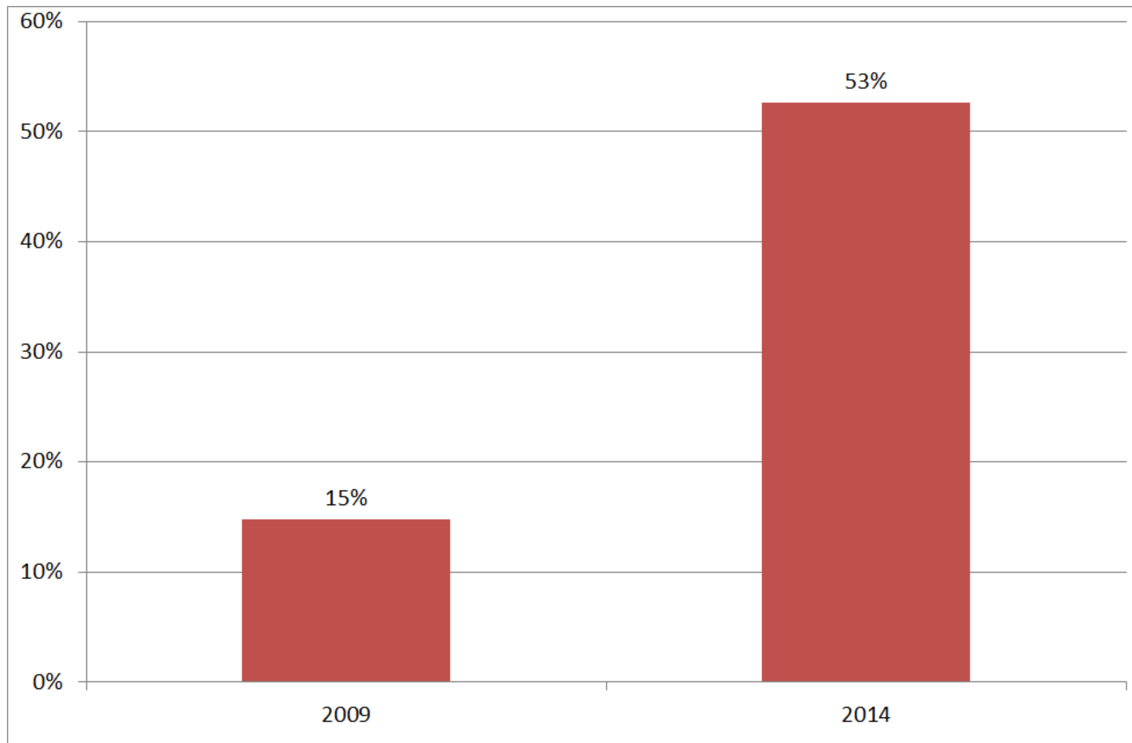
	Amount (€m)
Assumed RAB, €m	1000
Total cost of capital if WACC = 3.8% (bottom of range), €m	38
Allowed return on capital given WACC = 5.8% (point estimate), €m	58
Maximum safety net, €m	20
Maximum safety net, %	53%

As the table shows, the total maximum size of the allowed safety net is much higher than in the previous Determination both in absolute terms and in percentage terms.

In absolute terms, the size of the safety net has (under our notional RAB assumption of €1bn) increased from €9m to €20m. This is the direct result of the range used by the Commission this time being much wider than in the 2009 Determination: from 100 basis points (6.1% to 7.1% in 2009) to 210 basis points given the range that the Commission is currently proposing (3.8% to 5.9%).

In percentage terms, the difference is even more striking. As shown in Figure 2, the maximum size of the safety net in percentage terms has increased from 15% in 2009 to 53% under the present Draft Determination. That is, if the true WACC was equal to the bottom end of the range identified by the Commission, the proposed allowed WACC would allow Dublin Airport to earn a return on capital that is as much as 53% higher than the true cost of capital. Such an "excess profit" is hard to reconcile with the Commission's duty to protect the interests of users.

Figure 2: Maximum size of safety net in percentage terms, 2009 Determination and 2014 Draft Determination



Source: RBB calculations

The above result is not only related to the range assumed by the Commission being much wider than in the 2009 determination, it is also related to the absolute values of the WACC having fallen. A safety net of 100 basis points is relatively small relative to the absolute level of the WACC when the WACC may be around 6%, as was the case in 2009. But at a possible WACC of less than 4%, a safety net of more than 200 basis points has a very significant impact.

5. Conclusion

As our discussion above has shown, the cost of capital that the Commission has assumed for Dublin Airport is almost certainly overly high. The Commission has assumed an overly high cost of debt as well as an overly high safety net.

If a cost of debt of 1.5-2.0% was assumed, the WACC would be in the range of **5.0-5.3%**. Such figures are still in the high end of the range of 3.8% to 5.9% that the Commission has identified, thereby still providing Dublin Airport with a sizeable safety net.

RBB Economics
24 July 2014