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

27th November 2020

Dear Adrian,

This document provides Aer Lingus' feedback on the Commission for Aviation Regulation's Draft Decision on Interim Review of the 2019 Determination relating to 2020 and 2021 as set out in CP9/2020.

In responding to CP3/2020 Aer Lingus agreed that there were substantial grounds for interim review of the 2019 Determination. This agreement was based on the necessity to recognise the severe impact of the Covid-19 pandemic on all stakeholders within the aviation sector. While pragmatic decisions may be required in the short-term to protect the continued viability of the sector, such decisions should seek to maintain the integrity of the overall regulatory process to the greatest extent possible. It is these two considerations – pragmatism and the preservation of regulatory certainty to the greatest extent possible - which inform this response to CP9/2020.

<u>2020 Price Cap</u>

The proposal contained in the draft decision relating to the 2020 price cap is to remove all triggers and adjustments from the base price cap as set in the 2019 Determination. Aer Lingus cannot support this position. While in this case the proposal would see the price cap being marginally reduced, a dangerous precedent would be set for the remainder of the current period and future periods if retrospective changes to the price cap (outside of those known as possible by all parties at the outset e.g., service quality penalties) were to be allowed.

Airlines have no ability to retrospectively increase fares to passengers once tickets are sold and flights taken so it would be fundamentally unfair to expect that they would plug gaps in revenues which arise for the regulated entity where the price cap is allowed to change at the end of the year in which the airlines have already carried out their business. While daa could not have foreseen the impact of Covid-19 at the beginning of 2020, the same is true for airlines. In the interest of fairness therefore, no unforeseen retrospective changes to the price cap be made in these circumstances, nor indeed in any others.

Aer Lingus consider the underlying principle of certainty provided by ex-ante setting of price caps to be too important, to all parties, to be set aside.

Volume Risk

The longstanding regulatory framework at Dublin Airport allocates all traffic risk to daa. A risk that daa is compensated for in assessing the WACC that derives its expected return.

There exists no concept in regulation of a "normal" volume risk that the circumstances caused by Covid-19 now falls outside.

In any industry there is a risk of a catastrophic falloff in demand – if this were not compensated through the WACC it would suggest that investors knowingly take on a level of risk (including that of a catastrophic fall-off in demand) for which they do not expect to be adequately compensated through the WACC. This would be an irrational position and we do not believe this to be the case.

Aer Lingus recognise the need for pragmatism given the importance of Dublin Airport as a piece of critical state infrastructure, however t full volume risk was compensated through the WACC set in the 2019 Determination. If the regulator views the current circumstances as outside "normal" risk (which would need to be defined) then Aer Lingus would expect the WACC to be revised down in any future building blocks review.

Potential Over-recovery in 2020

In section 5.3 it is proposed that "Dublin Airport [not be required] to refund airport users for a likely over-collection in 2020, provided that it does not increase the individual charges from the levels set out in Appendix 1". Our own (necessarily, not fully informed) estimate of the potential over-recovery by daa in 2020 is c. €7m.

If this estimate is indeed within the ballpark of any actual over-recovery which will be made, then it would represent a substantial subsidy of the regulated entity by airlines, who have also been severely negatively financially impacted by the current circumstances.

However, in much the same way as daa will require airlines to survive into 2021 for it to have customers, airlines will also need a functioning Dublin Airport in 2021 to be able to service their customers. There is a pragmatic consideration to be made here in determining whether a waiver of the requirement to return over-recovery to airlines should be granted.

It is noted that other airports subject to price cap regulation (e.g. Schiphol Airport, Brussels Airport) implemented more immediate and substantial cost-reduction measures throughout 2020 than was evidenced by daa.

daa needs to demonstrate that it has taken all appropriate action to manage its cost base throughout the crisis and that meeting its obligation to return over recovery would impede its ability to operate efficiently in the short to medium term.

Moreover, investors and not customers need to be the first recourse to ameliorate daa's financial position. This is the approach across the airline industry. Therefore, if daa is truly unable to pay-out any 2020 over-recovery, then it may need to seek additional debt or equity investment to fulfil its financial obligations. Unless it can be demonstrated that the pay-out would cause serious financial damage to daa (such that it could not continue to operate) and all avenues to raise further financing have been exhausted, Aer Lingus would not support the waiver of the requirement to pay out over-recovery in Q1 2021.

However, if these two conditions are met then Aer Lingus could be prepared to support the waiver in the interests of maintaining a functioning Dublin Airport in the immediate term.

2021 Price Cap

A price cap of €7.50 is proposed for 2021. Noting the interplay of annual price caps and seasonal based pricing by daa this would be expected to somewhat increase charges from Q2 onwards in 2021. This is because charges should have been set from summer 2020 onwards to come in below €7.58 (perhaps around €7.15/€7.20 level) so as to compensate for the pricing in Q1 2020 being aligned with a €9.30 price cap for 2019.

Therefore, it's likely that pricing in Q2 2020 onwards will increase to above €7.50 per pax to compensate for Q1 being below €7.50 (assuming daa would intend to price to the cap). Additionally, although likely to result in an increase in prices to airlines from Q2 2021, this increase is probably at the lowest level which could be considered within the framework of the current regulatory settlement. It is important that prices be kept as low as possible to allow Dublin Airport to maintain its customer base and to support its long-term viability.

The proposal here is to set an ex-ante price cap which accords with the principle of regulatory certainty and setting the level of €7.50 potentially minimises the price increases to airlines in 2021, at a time of financial weakness, and so serves to support the longer-term financeability of Dublin Airport. On this basis Aer Lingus supports the setting of a €7.50 price cap for 2021.

However, it is not clear if the proposal to remove all triggers and adjustments from the base price cap as set in the 2019 Determination and therefore set a €7.50 price cap for 2020 and 2021 gives rise to the proposal not to "clawback" unspent capex from 2020 and 2021, or whether they are two completely separate proposals.

The capital allowances made for 2020 and 2021 were substantial, with €100m (2019 prices) flowing into the price caps in those years combined through depreciation and return on investment from new capex.

Not to claw back allowances for unspent capex as would be expected under the RAB roll-forward principles, would imply users paying for capex that does not exist. Section 3.9 of the draft decision paper states "We did not envisage that this review would make any changes to the core aspects of the 2019 Determination building block allowances or the risk allocation" and therefore taking a decision on how to treat unspent capex in 2020 and 2021 would seem to be inconsistent with that intent.

Aer Lingus' view is that the treatment of unspent capex allowances should only be considered in any forthcoming interim review of the building blocks of the 2019 Determination and no decision on the treatment of unspent capex made in the current narrow-focus review.

Consultation on Capex Projects over €4m

The draft decision contains a proposal to introduce a meaningful consultation process for substantial Capex projects (projects over €4m) which Dublin Airport might want to progress in 2020 or 2021 (Section 7.7). The rationale given for this new consultation process is to protect future users from costs which could arise from capacity over-provision and to avoid a perverse incentive for daa to proceed with capacity projects which are not required to facilitate the level of traffic, but which would nevertheless allow for the recovery of capital costs.

To the extent that the proposed consultation be limited to agreement on the **timeline** for the delivery of the projects and not the overall need for the project to facilitate a 38m passenger volume at some point in the future, Aer Lingus supports this proposal.

The suitability and desirability of the projects to facilitate a 38m passenger flow has already been extensively consulted upon with strong agreement from airlines for the current CIP projects and should not be revisited, particularly in light of the reduced resources available to airlines to engage effectively in protracted and complex consultation processes. We note that any proposal by daa to advance the projects in 2020 and / or 2021 will require agreement from airlines representing 50% of traffic.

Other Items

1. *Proposal to remove the opex pass-through mechanism*. On the grounds that it is a pragmatic response to the high level of uncertainty in both the 2020 commercial rates which will be imposed on daa and the 2021 passenger volumes and could therefore give rise to a far higher variability in the final price cap than was intended when the 2019 Determination was made Aer Lingus supports the removal of this mechanism
2. *Proposal to remove the commercial revenue roll-forward mechanism*. As Aer Lingus has no data on the potential size of any "outsized gain" which would result from the continuation of this mechanism, and in the interests of both fairness to all parties and the principle of regulatory certainty we would require more information on why the removal of this mechanism is considered by the CAR to be necessary.

Aer Lingus appreciates the opportunity offered to provide feedback on the proposals contained within the Draft Decision on Interim Review of the 2019 Determination relating to 2020 and 2021. If you would like to discuss any of the views expressed in this response document in further detail, we would be pleased to arrange a meeting with you for that purpose.

Yours sincerely,

____

Reid Moody
Chief Strategy and Planning Officer