



DUBLIN AIRPORT
Regulatory Model Strategic Considerations
5th March 2021

Contents

| | |
|---|----|
| Executive Summary..... | 1 |
| 1. Introduction..... | 3 |
| 1.1 Introduction | 3 |
| 1.2 Regulatory Model..... | 3 |
| 2. Determining the appropriate form of regulatory oversight | 6 |
| 2.1 Introduction | 6 |
| 2.2 Considering the extent of regulatory oversight..... | 7 |
| 2.3 Airport Market Consideration..... | 10 |
| 2.4 Economic Regulation Best Practice..... | 11 |
| 3. Alternative forms of regulation..... | 13 |
| 3.1 Regulatory regimes to consider | 13 |
| 3.2 Shadow Price Cap with negotiated settlements..... | 13 |
| 3.3 Price Monitoring | 16 |
| 3.4 Conclusion..... | 17 |
| 4. Long-term modifications to the regulatory building blocks..... | 19 |
| 4.1 Introduction | 19 |
| 4.2 Risk Sharing Mechanisms..... | 20 |
| 4.3 Cost Assessment | 24 |
| 4.4 The Regulatory Till | 26 |
| 4.5 Price Cap Compliance..... | 30 |
| 4.6 Price Control Duration | 30 |
| 4.7 Regulated Entity Recapitalisation | 32 |
| 4.8 Conclusion..... | 36 |
| 5. Next Steps..... | 37 |

Executive Summary

Economic Regulation at Dublin Airport

The Final Determination for Dublin Airport for the period from 2020 to 2024, which was published by the Commission in October 2019, was a product of nearly two years of analysis, engagement and discussion between Dublin Airport, the Commission, airlines and other stakeholders at the airport. However, only five months after it was published, the impact of COVID-19 on traffic and revenue at the airport has meant that the assumptions made as part of this review are no longer relevant. The scale of the traffic and revenue loss is unprecedented, creating a platform for a fundamental rethink of the regulatory framework that is applied to Dublin Airport.

The 2020 Interim Review which the Commission undertook reviewed the price cap for 2020 and 2021. This was intended to deal with the immediate impacts of COVID-19. At the time of publication (December 2020) the Commission explained that broader issues are likely to be considered as part of a more wide-ranging Interim Review to take place during 2021 for the period 2022 onwards.

While the current focus of economic regulation is on addressing the immediate effects of COVID-19, it is important that the next regulatory review addresses the fundamental issues in the regulatory framework which have led to the need for such a review. In particular, a regulatory regime that leads to tightly specified outputs and a fixed price set by the regulator as part of five-year regulatory cycles does not reflect Dublin Airports degree of market power or the market circumstances in which we operate. Such a regulatory model, which relies on a reasonable degree of accuracy in forecasting, is poorly suited to the level of uncertainty and volatility that is likely to persist for a number of years.

At the very least, there will need to be a review of how regulatory forecasts are set and the allocation of risk. However, more substantial changes of approach—based on agreements with airlines rather than regulatory prescription—should be considered in light of this uncertainty and the low risk of Dublin Airport earning a return in excess of the cost of capital. Importantly, Dublin Airport and the Commission must be alive to the long-term strategic challenges facing the aviation sector, particularly around net zero carbon, and seek to adopt a regulatory framework that will allow the industry to best address these challenges together. Greater flexibility and agility must be built into the regulatory model to ensure that Dublin Airport is able to deliver the best outcomes for users and Irish society.

Dublin Airport's Request

There has never been a more opportune time to undertake a fundamental rethink of the regulatory model in place. We must all draw on lessons learned since the inception of the Aviation Regulation Act in 2001 as well as international regulatory best practice. We strongly believe in the merits of implementing a shadow price cap with negotiated contracts approach or alternatively a price monitoring regulatory oversight arrangement as our preferred approach. Both options are explored in more detail in Chapter 3.

Should the Commission decide to retain the current price cap, building block approach, it is critical that both short-term and long-term modifications be considered and implemented to improve the application and fundamental workings of the current regulatory regime. These options are detailed in Chapters 4 and 5.

1. Introduction

1.1 Introduction

- 1.1.1 As a result of COVID-19, the Commission for Aviation Regulation (CAR) initiated an Interim Review of the 2019 Determination. It is intended that this will be a two phased approach with the stage 1 Interim Review Decision published in December 2020 specifically focusing on the regulatory settlements for 2020 and 2021 addressing the immediate consequences of the pandemic.
- 1.1.2 The Commission has outlined that stage 2 of the Interim Review will progress once there is greater clarity as to the impacts of COVID-19 on the business. This will likely look at the regulatory settlement for 2022 and beyond. The Commission suggested that this review is likely to be more wide-ranging and may consider issues such as whether any broad adjustments should be made to the regulatory model.
- 1.1.3 This report sets out our proposals regarding the longer-term regulatory approach at the airport, which will be considered as part of the stage 2 review for the period from 2022.

1.2 Regulatory Model

- 1.2.1 Since 2001, the Commission has applied a regulatory price cap model in the regulation of airport charges at Dublin Airport, We have been subject to five consecutive regulatory determinations and in each case these determinations were based on the original price cap model first introduced in 2001. Four of these five regulatory determinations have been appealed, where an Aviation Appeal Panels has been convened by the Minister for Transport to re-examine different aspects of the individual determinations.
- 1.2.2 Dublin Airport believes that the current regulatory price cap model results in a level of regulatory oversight which we believe to be excessive and disproportionate to the level of market power being held by Dublin Airport.
- 1.2.3 We are of the view that the price cap model was originally designed to safeguard consumer interests in a utility setting and that as such this is not entirely appropriate for the airport sector where there is no direct relationship between airport charges and consumers. In addition, the airport's customers are in fact the airlines who themselves hold a sizable degree of market power. This is quite a different market dynamic to that of the utility sectors which the Littlechild price cap regulatory model was designed to regulate.

- 1.2.4 The current regulatory model has given rise to substantial regulatory cost and we have not been persuaded that the benefits of the current system outweigh this cost.
- 1.2.5 The regulatory model in its current form subjugates an unwieldy approach to the assessment of the regulatory building blocks and the composition of the regulatory till. In particular we believe that the current formation of the single till has subjected a number of our commercial businesses to the vigour of regulation without any economic justification.
- 1.2.6 In addition, since the introduction of price cap regulation in 2001, there has been a wide degree of fluctuation in aeronautical pricing due to the variation in the annual price cap. This is not ideal for an industry such as aviation where capacity and business planning need to be carried out.
- 1.2.7 All parties would also firmly agree that the current regulatory model is a somewhat static and is evidently limited in its ability to react to changing market conditions in the regulated sector. This is evidenced by the fact that three of the five determinations have required interim reviews since the Commission's inception in 2001.
- 1.2.8 Furthermore, the price cap regulatory model should only be used where the regulated entity not only has strong market power but there is evidence of market abuse. While we acknowledge that the Indecon market power assessment which was undertaken in 2015 concluded that Dublin Airport had significant market power, there has never been a case or concern of market abuse from Dublin Airport.
- 1.2.9 As ACI has recently outlined¹ there is increasing evidence that there is effective competition in the marketplace for providing airport service, particularly for airports serving airlines that operate from multiples bases and/or multiple hubs. These airlines can switch their aircraft between bases and routes. As a result, an airport facing a small number of large buyers may also face a disproportionate response to any change in airport charges. In recent months airlines have exerted this market power to suggest that they will only restore connectivity of their services post COVID-19 in airports that have cut their airport charges.
- 1.2.10 We believe that this is a somewhat unreasonable position particularly given that we have not sought to immediately put up airport charges following the exceptional demand shock. However the airlines' approach appears to be that prices should

¹ ACI, Re: Consultation paper on the COVID-19 price regulation response for airport charges at Dublin Airport (CP3/2020), August 2020

always fall (when volumes are growing they should fall ; when volumes are failing they should fall) we are not sure how this position can be equated with retaining investment in the airport over the longer term.

- 1.2.11 We are of the view that this is the most opportune time to re-examine the justification for the current form of price cap regulation at Dublin Airport and for consideration of the use of viable alternatives such as price monitoring going forward. Should the Commission prefer to retain the price cap model, we would request that necessary modifications are progressed, allow all parties to progress with our statutory obligations and Dublin Airport's commercial mandate.

2. Determining the appropriate form of regulatory oversight

2.1 Introduction

- 2.1.1 Since the introduction of the Aviation Regulation Act in 2001, Dublin Airport has been subject to a regulatory price cap set by the Commission every five years. Despite considerable changes in the aviation sector, the regulatory model has remained largely the same since its inception, with changes limited to the modification of the treatment of particular building blocks (e.g. some commercial investments can be undertaken outside of the till).
- 2.1.2 Regulator-set price caps can have benefits when a company does not face effective competition, and there is a concern that it may exercise its high degree of market power, in order to ensure that the interests of passengers are protected. In such circumstances, regulation can help to secure fair prices, appropriate levels of capital investment, efficient costs, and levels of service quality that are aligned with passenger/user expectations. However, where regulation is not needed, or where regulation is overly restrictive or burdensome, it can be costly (both in terms of direct and indirect costs) and can lead to poor outcomes for customers. It is therefore important to ensure that the form of regulation is tailored to a firm's market position and the nature of competition concerns.
- 2.1.3 Dublin Airport believes that there is currently a significant discrepancy between the extent of the 'market failures' that would arise if outcomes were delivered by market forces and the prescriptiveness of the regulatory framework that is in place. Indeed, the regulatory framework is very similar in design to the frameworks applied at the largest airports across Europe, such as Heathrow Airport, Aena and Aéroports de Paris (AdP). The regime applied at Dublin does not take account of the considerable differences in market dynamics relative to these airports, and the limited scope for us to exercise any market power we hold given our market position and the countervailing buyer power of the main airlines at the airport. In addition, even at many of these airports there is more flexibility afforded to the airport than is the case at Dublin Airport.
- 2.1.4 More light-handed regulatory regimes have been introduced at a number of airports across Europe, such as Gatwick Airport, based on changing market conditions, an assessment of the degree of market power of the airport, and an analysis of the costs and benefits of a high degree of regulatory intervention. These factors should be taken into account in determining the appropriate regulatory regime for Dublin Airport going forward.

- 2.1.5 We also consider that it is particularly relevant to review the regulatory regime at the airport in light of the COVID-19 pandemic. COVID-19 has demonstrated the issues that can arise in applying the current regulatory model, which requires a reasonable degree of accuracy in forecasting costs, traffic, commercial revenue, and a number of other parameters in an uncertain and potentially volatile environment. As further discussed in section 3, the regulatory model in place at Dublin Airport will also mean that the significant decline in traffic as a result of COVID-19 will lead to a sharp increase in charges which airlines and passengers are unlikely to be able and/or willing to pay for in the current conditions. This could in turn create financeability issues for the airport. Therefore, changes need to be made to the regulatory regime in order to reduce the impact of these types of shocks on the airport and users and given that there is likely to be continued uncertainty in the sector for some time.
- 2.1.6 This section sets out our view on the regulatory oversight that we consider would be appropriate at Dublin Airport given the degree of market power that the airport holds, a consideration of the benefits and costs of different forms of regulatory intervention, and the effects of COVID-19.

2.2 Considering the extent of regulatory oversight

- 2.2.1 It is important that regulation imposed is calibrated to the degree of market power identified. Regulators, governments and competition authorities around the world undertake market power assessments of firms across industries in order to determine whether regulatory oversight is required, and if so, to tailor it to the degree of market power.
- 2.2.2 For example, in both the electronic communications and the terminal air navigation services (TANS) sectors, there are European Commission frameworks for undertaking market power assessments and for determining whether there should be any form of economic oversight applied. In the electronics communications sector, the European Commission framework explains that if a market is subject to effective competition, then the national regulatory authority (NRA) cannot impose any regulation. If competition in the market is not effective, the regulator must impose some form of regulation, although 'any obligation imposed by NRAs must be proportionate to the problem to be remedied.'²

² European Commission (2002), 'Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services', para. 117.

- 2.2.3 There are also a number of examples of market power assessments being applied in the aviation sector in order to determine the appropriate form of economic regulation. For instance, the Civil Aviation Act 2012 grants the UK Civil Aviation Authority (CAA) powers to undertake market power assessments to determine whether to regulate an airport and, if so, the form that this regulation should take.
- 2.2.4 The market power test is one of three tests the CAA undertakes to determine whether regulation should be introduced. The first test determines whether the airport has, or is likely to acquire, significant market power (SMP). If SMP is found, the CAA proceeds to the second test and considers whether competition is sufficient to constrain the behaviour of the operator. If this is not the case, then in the third test the CAA assesses whether the benefits of regulation are expected to outweigh the costs.
- 2.2.5 In 2013-2014, the CAA undertook market power assessments for each of Heathrow, Gatwick and Stansted airports in order to determine whether to regulate, and the appropriate form of regulation for the next price review period. The CAA ultimately came to different decisions on regulation for each airport based on the degree of market power identified:
- Stansted was determined not to have SMP and was de-regulated (i.e. it no longer requires an economic licence);
 - Heathrow was found to have a high degree of SMP and the CAA determined that the benefits of price cap regulation outweigh its costs;
 - Gatwick was found to have some degree of market power, and continued to be regulated with a licence, but the price cap regime was modified such that development of commercial relationships between the airport and airlines was encouraged.
- 2.2.6 Importantly, deciding whether to regulate, and the appropriate form of regulation, does not solely depend on whether a firm has market power, but also on whether the firm is likely to exercise that market power. For example, in Australia, although the Productivity Commission determined that the largest airports had market power, there was no evidence that this would lead to anti-competitive behaviour due to the market constraints faced by the airports (e.g. buyer power of airlines, pursuit of new airline business). As a result of these constraints, and the direct and indirect costs of heavy-handed regulation,³ price cap regulation was replaced by a lighter touch regulatory regime in 2002 and has remained in place ever since. Notably this new regime was introduced immediately following 9/11 as it was recognised that there would be significant challenges in establishing robust regulatory forecasts for a multi-year price control. This is a similar situation to that facing the Commission and Dublin

³ The Productivity Commission cited discouraging efficient investment by sending poor price signals to users and the airport about the costs of providing aeronautical services as one of the costs of the price cap regime.

Airport in the wake of COVID-19. When the price cap model was introduced in 2001 the two largest carriers had 65% share of the total market. This has now increased to approaching 80%, evidently a dramatic shift in bargaining power.

- 2.2.7 While not required by the Aviation Regulation Act, as part of the development of the National Aviation Policy in 2015, the Department of Transport, Tourism and Sport (DTTaS) committed to an independent review of airport charges regulation. As part of this review, it undertook market power assessments for Dublin, Cork and Shannon airports. The DTTaS suggested that regulation should only be imposed where an operator has SMP due to the costs associated with regulation. It also explained that if regulation needs to be imposed, it should be tailored, maximise benefits and minimise costs.⁴ The DTTaS ultimately determined (on the basis of a report by Indecon) that Dublin Airport had SMP and should be price regulated through a regulator-determined price cap, whereas Shannon and Cork face effective competition and should not be regulated.⁵
- 2.2.8 In SMP assessments, there is no single definitive piece of evidence that determines whether a firm has market power, and evidence needs to be considered in the round. SMP is also not binary; it is a matter of degree and the nature and strength of competitive constraints should be used to tailor the form of regulation. This is important, as the design of the regulatory regime can be amended according to different degrees of market power, even within a broad ‘price cap’ framework—e.g. by allowing for more aspects of the price and service quality settlement to be determined through airport–airline negotiations where there is a lower degree of market power.
- 2.2.9 Overall, we consider that the market power assessment undertaken by Indecon failed to take account of a number of factors that affect the degree of market power held by Dublin Airport and our ability to exercise any market power that we hold. For example:
- Indecon considered concentration measures based on three airports in the Republic of Ireland, which does not reflect the existence and strength of competitive constraints faced by Dublin Airport from airports beyond those in the immediate catchment area.⁶
 - The analysis did not reflect the extent of the bargaining position held by the airlines at the airport—e.g. it only considered actual switching over a limited time

⁴ Department of Transport, Tourism and Sport (2017), ‘National Policy Statement on Airport Charges Regulation’, 20 September, p. 8.

⁵ Indecon International Economic Consultants (2016), ‘Review of the Regulatory Regime for Airport Charges in Ireland’, 11 March.

⁶ For example, see Oxera (2017), ‘The continuing development of airport competition in Europe’, September.

period, and did not take account of the threat of switching or airlines allocating new capacity to other airports.

- Indecon also did not assess whether, even if the airport had market power, it would be able to exercise this market power.
- Furthermore, never has the competition between European airports been so profound, with airlines demonstrating no loyalty to any particular airport or region, where they are ultimately seeking the most competitively priced airports for bases.
- Importantly, this assessment was also undertaken five years ago. There have been a number of significant changes in the market since this time.

2.2.10 Given the changes that have occurred in the market since the last assessment, we consider that a new market power assessment of Dublin Airport should be undertaken. Indeed, in line with regulatory best practice, Indecon highlighted that the continued need for regulation, and the appropriateness of the current regulatory approach, should be considered if and when there are changes in market dynamics. COVID-19 has clearly significantly altered the market, and Dublin Airport's operations, relative to the 2016 assessment.

2.2.11 However, given the uncertainty currently facing the industry, we acknowledge the difficulties in undertaking a market power assessment at this time. While we consider that another assessment would be useful once the industry recovers from the current crisis, at this stage we would request that the Commission re-evaluates certain aspects of the previous assessment in order to consider whether Dublin Airport is likely to be able to exercise significant market power.

2.2.12 If this assessment were undertaken, we believe that the Commission would conclude that less regulatory oversight would be more in line with degree of market power held by Dublin Airport. In addition, given the difficulties in applying the existing RAB based model in the face of significant shocks such as COVID-19, and the costs of applying the current form of regulation, a shift in the form of regulatory oversight applied would ultimately lead to better outcomes for users.

2.3 Airport Market Consideration

2.3.1 We believe that there is now significant competition between airports for route development both nationally and internationally across Europe. In many cases a number of airports that are actively competing for airline business are also subject to the economic regulation of their aeronautical charges.

- 2.3.2 A comprehensive assessment of airport market power was carried in 2012 by Copenhagen Economics⁷ where it was found that developments in the European airline industry had intensified competition between airports therefore there was only justification for the implementation of economic regulation where absolutely necessary to limit an airport's market power.
- 2.3.3 A further study by Oxera⁸ in 2017 found active competition between airports for airline routes plus competition for connecting passengers. More recently in 2020, Bilotkach and Bush⁹ looked at airport competition from an airline's perspective and found strong evidence of an increase in competition between airports for route development and airline demand for airport services over the past ten years.
- 2.3.4 The Bilotkach and Bush study also highlighted the concern that the rigid regulatory environment that airports find themselves in could in fact restrict their ability to compete effectively within the airport market. There was a recognised need for regulators to re-evaluate their approach to regulation and to ensure that there is sufficient flexibility in the regulatory regime to allow for effective competition between airports.

2.4 Economic Regulation Best Practice

- 2.4.1 The current regulatory model applied at Dublin Airport is based on the regulatory model first developed by Stephen Littlechild¹⁰ back in the 1980s in the UK to address concerns in the wake of the privatisation of a number of UK utilities.
- 2.4.2 We are of the view that the price cap model was originally designed to safeguard consumer interests in a utility setting and that as such this is not entirely appropriate for the airport sector where there is no direct relationship between airport charges and consumers. In addition, the airport's customers are in fact the airlines who themselves hold a sizable degree of market power. This is quite a different market dynamic to that of the utility sectors where the Littlechild regulatory model was designed to regulate.

⁷ <https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/5/195/0/Copenhagen%20Economics%20Study%20-%20Airport%20Competition%20in%20Europe.pdf>

⁸ <https://www.oxera.com/publications/the-continuing-development-of-airport-competition-in-europe/>

⁹ Bilotkach and Bush, Airport Competition from airports' perspective: A survey of European Airports, CRNI 2020 vol. 21(3) 275-296.

¹⁰ Stephen Littlechild, "Ten Steps to Denationalisation", *Journal of Economic Affairs*, Vol 2 No 1 October 1981. Stephen Littlechild, "The birth of RPI-X and other observations", in Ian Bartle (ed), *The UK Model of Utility Regulation*, CRI Proceedings 31, University of Bath, July 2003.

- 2.4.3 As previously outlined this regulatory model does not take account of the high level of competitive forces at play in the airport market where individual airports compete with each other to attract and retain airlines services.
- 2.4.4 The limitations of the traditional RPI-X model and its incompatibility with competition was highlighted by Stephen Littlechild¹¹ where he concluded that the conventional approach to setting price controls is a painful and costly process that does not necessarily lead to the best outcomes for customers or companies – or for regulators. He highlighted his positioning that there must be another and better way, involving more customer engagement with the prospect of some form of negotiated agreement that can be proposed to the regulator.

¹¹ Stephen Littlechild: RPI-X, competition as a rivalrous discovery process, and customer engagement, LSE, London, 31 Mar 2014.

3. Alternative forms of regulation

3.1 Regulatory regimes to consider

- 3.1.1 There are alternative forms of regulation which we believe would lead to better outcomes for airports users and ultimately the consumer.
- 3.1.2 All airports in Europe are subject to competition law,¹² and airports with more than 5m ppa (or the largest airport in the Member State) are required to comply with the Airport Charges Directive (ACD). The ACD establishes a common European framework for regulating features of airport charges, airports' operations, and airports' interactions with airlines.¹³ While some airports are only subject to the ACD, many national regulators have imposed various forms of additional regulation beyond the ACD.
- 3.1.3 Below we set out two types of regulatory regimes that would be more appropriate than the current regime at Dublin Airport given the degree of market power held by the airport. These forms of regulation would represent a shift in approach for the Commission, Dublin Airport, airlines and other stakeholders, but a number of aspects of the current regime would be retained.
- 3.1.4 These regimes would also be better suited to an industry continuing to face uncertainty as it recovers from COVID-19 and would be better able to address future shocks that arise over the course of a regulatory period. Examples from jurisdictions where there has been a change from price cap regulation to one of these alternative forms of regulation demonstrate an improvement in outcomes for users.
- 3.1.5 While we consider two broad types of regulation, we note that there are a number of different ways they can be applied and would welcome further discussion with the Commission on these matters.

3.2 Shadow Price Cap with negotiated settlements

- 3.2.1 In this type of regime, Dublin Airport would be encouraged to reach agreement on price, service quality and investment outcomes directly with airlines as part of contracts for a multi-year period. These agreements could either be formed

¹² According to the Treaty on the Functioning of the European Union (TFEU).

¹³ European Commission (2009), 'Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges', *Official Journal of the European Union*. OJ L 70/11, 14 March.

individually with each airline (bilateral commitments) or as a single contract that applies to all airlines (multilateral commitments).

- 3.2.2 The regulator would still have an important role in this regime in terms of setting a shadow price control—i.e. a price cap that would apply in case there is no agreement between the airport and airline(s). One alternative is for the regulator to set out the shadow price control in advance and then the airport’s negotiations with users would occur within this framework. Airlines and the airport could form agreements with parameters that differ from this shadow price control, but if they do not come to an agreement, then the regulator’s regime would be applied.
- 3.2.3 This is the type of regime that was put in place at Gatwick Airport in 2014. The CAA set out what it considered to be a ‘fair price’ benchmark,¹⁴ but Gatwick then formed commitments with its airline customers within this default tariff (i.e. limit on aeronautical revenue per passenger) and service standards. After this regime was put in place, the CAA noted that airlines did not wish to see a return to a traditional price cap regime.¹⁵
- 3.2.4 Consultation is currently ongoing for the next regulatory period at Gatwick. Gatwick has proposed a new set of commitments. The CAA has assessed that the commitments are consistent with protecting the interests of users, and it is therefore consulting on accepting Gatwick’s commitments.¹⁶
- 3.2.5 Another form of this regime is where the regulator establishes a shadow price cap only if the airport is not able to reach agreement with its users. This is the regulatory regime in place at Copenhagen Airport, which is based on a codified framework of commercial negotiations between Copenhagen and its main airlines. The regime falls back to provisions for a regulator-set price cap if agreement cannot be reached.
- 3.2.6 This type of regime has been introduced in other sectors. In the Scottish water sector, the last two price reviews have revolved around Scottish Water reaching an agreement with an independent customer representative body (the Customer Forum) on the company’s business plan and price path. The regulator (WICS) has endorsed the agreements in its determinations. For the Strategic Review of Charges 2021-27, this approach has been extended beyond a bilateral ‘negotiation’ between Scottish Water and the Customer Forum to a new approach in which Scottish Water has co-

¹⁴ The CAA fair price benchmark is the price that the CAA believes would prevail in a competitive market without capacity constraints.

¹⁵ Civil Aviation Authority (2016), ‘Economic regulation: A review of Gatwick Airport Limited’s commitments framework—Findings and conclusions’, CAP 1502, December, p. 38.

¹⁶ CAA (2020), ‘Economic regulation of Gatwick Airport Limited: consultation on new commitments’, CAP 1973, October.

created its Strategic Plan based on close collaboration with six stakeholder organisations.¹⁷

- 3.2.7 This approach, based on the principles of Ethical Business Regulation, has focused on providing Scottish Water with the opportunity to demonstrate that it is working collaboratively with other stakeholders in a way that engenders trust and involves high levels of transparency around performance, risks and options. A key feature of this framework is that there is less prescription from the regulator and Scottish Water has been given greater freedom to define the types of information that it reports. Regulatory oversight is instead based on the concept of ‘Seek Trust but Expect Verification’—i.e. the company should be relied on to communicate its performance to stakeholders in a way that is intended to build trust, but should expect to provide verification to the regulator when requested.
- 3.2.8 In this regime, the regulator would still establish, guide and approve the process by which the outcomes are determined. For instance, the regulator would need to set out the principles and process for negotiations, potentially approve the final terms of the negotiations, and monitor compliance and outcomes on an ongoing basis to ensure the outcomes are in the interests of end users.
- 3.2.9 Another example of this approach in practice is in the Northern Ireland Gas Transmission market, where the Utility Regulator determines an efficient level of operating costs under a shadow price control on the licence holders Gas Networks Ireland (UK) and Mutual Energy Limited¹⁸. In this instance the licence holders have a reputational incentive to manage costs effectively in line with the determined ‘shadow’ allowances.
- 3.2.10 This works under the auspice that the regulated entities management incentives are set to align with these allowances as a means of effective operating cost control. Performance under the shadow allowance also provides the Utility Regulator with a metric to judge whether the regulated licences in place facilitate all parties’ statutory duties.
- 3.2.11 Furthermore, we note that the Aviation Regulation Act 2001 is aligned with the price cap model, and the shadow price control negotiated settlements approach could be applied within the existing legislative framework.

¹⁷ This includes the Drinking Water Quality Regulation, the Scottish Environment Protection Agency, the Scottish Government, Citizens Advice Scotland, the Customer Forum and WICS.

¹⁸ Price Control for Northern Ireland’s Gas Transmission Networks GT17, Final Determination, August 2017

3.3 Price Monitoring

- 3.3.1 An alternative model could be to introduce annual consultations and negotiations between the airport and users regarding the key outcomes for each year. While the regulator would still set out the information requirements and principles for pricing upfront, the regulator would leave the company and airlines to determine the target outcome(s). The company would be required to publish price, service quality and/or financial information each year.
- 3.3.2 There are typically two roles the regulator can take in these types of regimes: i) a more proactive role monitoring information; or ii) a more reactive role, only intervening if there is a complaint from a market participant.
- 3.3.3 For example, in New Zealand, Auckland, Christchurch and Wellington International Airports are subject to an information disclosure regime. While the airports are required to publish information according to guidelines and templates set out by the regulator, the regulator does not formally monitor this information each year and only intervenes if there is a formal complaint from a market participant about the company's behaviour. There is therefore a threat of more intrusive price regulation in the future if the airport does not deliver outcomes in line with consumers' interests.
- 3.3.4 In other cases, the company may negotiate with its customers and the regulator monitors outcomes on an ongoing basis to ensure the company is acting in line with consumers' interests. If not, the regulator may intervene. For example, in Australia, the Australian Competition and Consumer Commission (ACCC) monitors the airports' prices, financial performance, and quality of service and issues annual reports, including a comparison of airports' performance across certain KPIs on the basis of information submitted by the airports.
- 3.3.5 To determine the level of charges, bilateral negotiations between airlines and airports are carried out according to a set of formalised pricing principles and can be subjected to arbitration in the event that the parties are unable to agree on an outcome. The agreements, which are typically for 5-7 years, have agreed price paths with pre-defined variations in specified circumstances.
- 3.3.6 As noted above, this regime was introduced to help the airports recover from a 30-40% traffic decline caused by 9/11 and the cessation of services by the second largest Australian airline at the time. The Productivity Commission noted that the uncertainty in global aviation markets post 9/11 created a high risk of regulatory error:

*If airport operators themselves cannot predict what will happen over the next few months or years, regulators are unlikely to be able to fix price caps that can deal efficiently with future market conditions.*¹⁹

- 3.3.7 The regime was also changed as price cap regulation was determined to be too 'heavy-handed' given the nature of the market. Three reviews by the Productivity Commission have found that the move from price cap regulation to price monitoring has created benefits for users, including more investment, good levels of service quality and competitive prices.
- 3.3.8 We acknowledge that the current legislation is aligned with the price cap model, therefore we are aware that if the price monitoring method was to be pursued a legislative amendment would likely be required.

3.4 Conclusion

- 3.4.1 The current regulatory regime at Dublin Airport is one of the most onerous in Europe. Even among airports with the form of price control in place at Dublin Airport (e.g. Brussels Airport, AdP, AdR), there is more flexibility and less regulatory scrutiny. This is further discussed in chapter 4.
- 3.4.2 The conditions at Dublin Airport are such that there are clear benefits of implementing a regime which relies more on negotiations between the airport and its users. These types of regimes tend to work well when users in the downstream market have a degree of bargaining power and are well-informed, as is the case with the airlines operating at Dublin. Where airlines have countervailing buyer power, setting some price and/or non-price outcomes through negotiations with users can be preferable to regulator-determined outcomes for a number of reasons, including direct costs of regulation. Indeed, the UK CAA noted that the regime put in place at Gatwick 'avoids some of the distortions of RAB-based regulation in terms of management distraction and perverse incentives.'²⁰
- 3.4.3 This regime can also provide benefits when there are clear reasons for service quality, investment or other forms of differentiation between users, which is only possible through RAB-based regulation to a limited extent. These benefits have been evident since the introduction of this regime at Gatwick Airport. As part of the recent review of Gatwick's commitments, the CAA has stated that:

¹⁹ Productivity Commission (2002), 'Price Regulation of Airport Services', inquiry report no. 19, 23 January, p. XLIII.

²⁰ Civil Aviation Authority (2013), 'Economic regulation at Gatwick from April 2014: final proposals', CAP 1102, p. 9.

We also continue to consider that an economic regulation framework that facilitates bilateral discussions and contracts between Gatwick and airlines can be in the longer term interests of consumers. It allows the airport and airlines to develop price and service propositions that are tailored to their interests and consumers interests, rather than being subject to a single set of overarching price and service settings.²¹

- 3.4.4 Furthermore, there are particular benefits of this type of regime in an environment where there is significant uncertainty as airlines and airports can continue to engage with each other and make adjustments to contracts and/or commitments as circumstances change without the need for a full interim regulatory review.
- 3.4.5 We therefore consider that users' interests are unlikely to be best served by retaining the regulatory framework in its current form, and that a shift to a regime that relies on a more collaborative approach between the airport and our users, while retaining oversight by the Commission, is more appropriate.
- 3.4.6 However, to the extent that the Commission decides to retain the current price cap model for the next review, the Commission will need to consider how to address the uncertainty created by the COVID-19 pandemic, and ensure that we are able to remain financially viable, by making significant changes and improvements to the current regulatory regime. This is discussed in the following chapters.

²¹ CAA (2020), 'Economic regulation of Gatwick Airport Limited: Consultation on new commitments' CAP 1973, October, para 14.

4. Long-term modifications to the regulatory building blocks

4.1 Introduction

- 4.1.1 It is important that both Dublin Airport and the Commission are alive to the long-term strategic challenges facing the aviation sector and seek to adopt a regulatory framework that will best allow these challenges to be addressed. Dublin Airport's purpose is to connect the people and businesses of Ireland with the rest of the world, and vice versa. We play a central role in the Irish economy and in the lives of the Irish public by facilitating tourism and trade, and as an employer. We have an obligation to ensure that we are responsible stewards of Dublin Airport's assets and are doing everything we can to support the National Aviation Strategy.
- 4.1.2 The Commission's current regulatory framework revolves around five-year planning cycles with a fixed price contract and a tightly specified set of deliverables. There is a significant focus on cost reduction and prices. Investment appraisal is driven by the ability of the projects to earn a commercial rate of return and the willingness of airlines to pay for these investments. Inevitably, the 'fixed price' nature of the price review, and the investment planning process, have resulted in adversarial behaviours rather than a collaborative approach.
- 4.1.3 There is a clear risk that the rigidity of the framework and the focus on costs leads to outcomes that ignore the bigger picture. The aviation industry, perhaps more so than other sectors of the economy, will have to play its role in tackling climate change and contributing to decarbonisation. It is not obvious that the current regulatory approach is equipped to deal with these challenges.
- 4.1.4 We would therefore encourage the Commission to consider how its regulatory framework needs to adapt to ensure that Dublin Airport has the ability, flexibility and funding to make real progress towards net zero, while growing the airport to meet the demands of Irish communities and businesses, and to support the long-term growth of the economy. We consider it is undoubtedly the case that a joined up, collaborative approach will be more effective than an adversarial, prescriptive one. Particular areas to think about include:
- How to ensure that the regulatory framework allows Dublin Airport to adopt whole life cost principles, by trading off between operational and capital solutions?
 - How to ensure that the investment appraisal process appropriately captures external costs (e.g. carbon) and benefits (e.g. economic growth)?

- How the regulatory framework can take account of a broader set of issues than purely financial (efficiency) considerations—including social, human and environmental capital?
- Linked to the above, whether an approach based on ex ante ‘rules’ and ‘incentives’ encourages the right behaviours and is likely to address long-term challenges?
- The extent to which a greater level of collaboration is possible and would be of benefit to all parties?

4.1.5 We consider that there would be significant benefits of a change to the regulatory model on this basis. However, if the Commission ultimately decides to retain the current regulatory model for the next review, there are a number of areas where modifications to the treatment of the core building blocks is required to try to take account of these future challenges and to address the uncertainty that is likely to still exist in 2022 as the industry recovers from COVID-19. In particular, we consider that there is a need for:

- greater flexibility to allow Dublin Airport to work with its users to manage and respond to changing circumstances;
- a review of how risk is allocated between the airport and users.

4.1.6 Below we set out proposed changes in particular building blocks that would help in achieving these objectives, but we would welcome further discussions with the Commission about how these objectives can be achieved with broader changes to the regulatory framework going forward.

4.2 Risk Sharing Mechanisms

4.2.1 The current regulatory model applied at the airport assigns both the upside and the downside risks of outturns differing from forecasts to Dublin Airport, on the basis that we are the party best able to manage and/or control these risks. This applies across the different building blocks that need to be set as part of the price review process, including passengers, OPEX, commercial revenues and the cost of capital.²²

4.2.2 COVID-19 has had an unprecedented effect on Dublin Airport. Based on the current regulatory model, the significant impact caused by COVID-19 on traffic, which is completely outside of our control, would need to be fully borne by the airport. This

²² The per passenger price cap allocates volume risk to the airport and there are no ex post adjustments when outturn operating costs, commercial revenues or cost of capital differ from the targets set. CAR (2019), ‘Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024’, Commission Paper 8/2019, 24 October.

impact, and the uncertainty going forward, poses a significant risk to our financial viability.

- 4.2.3 As a result, the Commission has initiated the interim review process which can be used to re-open previous determinations if circumstances change significantly within a control period.²³ However, this is a lengthy and costly process, requiring engagement from all parties, and comes less than a year after the previous review was completed.
- 4.2.4 The introduction of a risk-sharing mechanism could reduce the need for interim reviews by allowing for more automatic and immediate responses to shocks through price adjustments within-period, to the benefit of the airport and users. This type of mechanism would also balance the allocation of risk where there are shocks that arise that have a significant impact on the business, but which are outside of our control.
- 4.2.5 In developing a risk-sharing mechanism it is important to consider its purpose and what areas it should cover. There are also a number of detailed design aspects that would need to be considered—e.g. whether the mechanism applies to under- and/or out-performance, the percentage of out/underperformance that is subject to sharing, and whether it is applied immediately or with a lag. While design aspects of a risk sharing mechanism will need to be discussed in more detail with the Commission before it can be implemented, below we set out two potential mechanisms that could be considered further as part of the next review.

Volume Risk Sharing Mechanism

- 4.2.6 There is a spectrum of approaches to volume risk allocation, from users taking full volume risk in a revenue cap framework to a firm taking full volume risk in a price cap framework. The current regulatory framework assigns all volume risk to Dublin Airport through the per passenger price cap. The Commission states that this volume risk allocation incentivises the airport to increase traffic in order to increase revenue, and that allocating volume risk in a different manner would weaken the incentive for Dublin Airport to grow traffic and respond to changing levels of demand.²⁴
- 4.2.7 The per passenger price cap is calculated using GDP based forecasting models to predict volumes. However, with significant uncertainty going forward, conventional GDP based forecasting models, or indeed any forecasting models, are unlikely to be able to accurately predict traffic. Factors such as border restrictions and vaccines are

²³ CAR (2019), 'Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024' Commission Paper 8/2019, 24 October.

²⁴ CAR (2019), 'Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024' Commission Paper 8/2019, p51 paragraph 5.30

likely to drive traffic recovery more than the typical factors considered in forecasting models.

4.2.8 It is therefore likely to be necessary to develop a range of scenarios for how traffic may evolve in setting the next price control. In turn, this is likely to mean that a scenario-based business planning approach will also be necessary for other elements of the price control settlement that depend on traffic (e.g. operating costs). However, the current regulatory model is not well equipped to deal with forecast scenarios for different parameters.

4.2.9 Regardless of the approach taken to business planning, with this degree of uncertainty going forward, a volume risk sharing mechanism may be useful in order to ensure that risks of traffic deviations from forecasts are shared between the different parts of the aviation value chain. This type of mechanism is being considered at other airports in light of COVID-19, including as part of the CAA's recent consultation for Heathrow.²⁵ The CAA noted that:²⁶

The outlook for passenger traffic at Heathrow airport is likely to remain uncertain as we develop the H7 price control. For this reason, our current view is that there may be a strong case for including some form of traffic risk sharing mechanism in HAL's price control. Such mechanisms have operated for an extended period at a number of other major European airports.

4.2.10 This is the reason that a traffic risk-share mechanism was introduced in the UK for NATS. The mechanism was introduced as part of a suite of measures after the significant and unanticipated downturn in traffic following 9/11 put pressure on NERL's financial position, and made it difficult to establish robust forecasts for a multi-year price control.²⁷ NERL bears all the risk on differences of up to 2% from the forecast traffic levels (i.e. there is a 2% symmetrical deadband), and 30% on the risk of differences up to 10%. For differences in excess of 10%, NERL is protected from all risk as it is all passed through to users with a two-year lag.

4.2.11 We consider that it would be appropriate for Dublin Airport to bear a significant proportion of the volume risk for small deviations from forecasts to ensure we maintain incentives to accurately forecast and grow traffic. In its recent review, the UK CAA noted that airlines were supportive of considering such mechanisms, though they did not consider that Heathrow should be 'de-risked' completely.²⁸

²⁵ CAA (2020), 'Economic regulation of Heathrow: policy update and consultation', CAP 1940, June.

²⁶ CAA (2020), 'Economic regulation of Heathrow: policy update and consultation', CAP 1940, June, para 1.29.

²⁷ NATS Price Control Review 2006-2010 CAA Decision December 2005, footnote 10

²⁸ CAA (2020), 'Economic regulation of Heathrow: policy update and consultation', CAP 1940, June.

- 4.2.12 However, the current framework requires us to bear the full risk of extreme traffic fluctuations that are due to factors outside of our control. At the same time, the fixed cost nature of our business means that we are unable to adapt to such dramatic reductions in volume in the short or medium term. This was one of the justifications for introducing a traffic risk-share mechanism at AdP as it was considered that it is 'in line with the specific nature of an airport operator's business model, whose cost structure is not very adaptable to the volume of activity in the short term.'²⁹ It therefore ensures an equitable sharing of traffic risk between AdP and the airlines.³⁰
- 4.2.13 We consider that it would be appropriate to introduce a volume risk share mechanism where we would bear all risk of out- or under-performance for traffic within a certain range of forecasts. This would preserve the incentivisation properties of the regulatory model (e.g. incentivising the airport to grow volumes), and ensure that time and costs are not spent making minor adjustments to the price cap formula within-period. However, an adjustment mechanism could then be added to the price cap formula to allow for changes to the annual price cap where volume fluctuations exceed a certain threshold symmetrically in both directions (i.e. for under- and over-performance).
- 4.2.14 For example, Aeroporti di Roma (AdR) has a traffic risk-share mechanism in place such that if traffic is within a range of 5% of forecasts, AdR bears all traffic risk. If traffic is greater than 5% of forecast, 50% of the higher income is set aside for future investments, while if it is more than 5% below forecasts, 50% of the lower income is included as allowed costs in the following five-year period. If traffic deviations are greater than 6% from forecasts, this may lead to a re-opening of the price control.
- 4.2.15 Volume risk sharing in this manner can help maintain the financial viability of Dublin Airport when there are shocks to traffic, while allowing users to benefit immediately from large positive deviations in traffic. It also provides aligned incentives between the airport and airlines to grow volumes as the parties will share the benefit of out- and under-performance on traffic forecasts.
- 4.2.16 For very significant deviations from traffic, it will be important to consider the balance between dealing with these shocks through a volume risk-share mechanism and

²⁹ Aeroports de Paris (Economic Regulation Agreement 2011-15).

³⁰ The traffic adjustment method (called the 'TRAF factor') measures deviations in passenger traffic, and specifies a buffer zone within which no adjustment to the tariff formula is made. The buffer zone for the 2011-15 charges period was set at +/-0.5% annual variance in passenger traffic. Beyond this buffer zone, 50% of the traffic deviation was applied to adjust all fee caps in the following year. The 2016-20 ERA adopts a cap to the TRAF factor proposed by AdP (-0.5% to +0.2% of the tariff cap). Within these limits, the TRAF factor is then calculated so that 50% of the surplus or 20% of the shortfall in the projected income from fees is offset by an adjustment of fee rates.

requiring an interim review. While a volume risk-share is likely to be able to deal with short and sharp spikes or dips in traffic, interim reviews are still likely to be needed in situations where there are longer sustained shocks to traffic that also require changes to the other building blocks of the price control.

4.3 Cost Assessment

- 4.3.1 As part of the process of setting the price control every five years, the Commission, Dublin Airport and users undertake a detailed assessment of required capital investments, including their scope, timing and cost. As noted above, we consider that this detailed bottom-up exercise risks missing the higher-level objectives of what should be achieved with such capital spending, and therefore a broader regulatory re-think may be required.
- 4.3.2 However, in absence of such a change, allowing for additional flexibility within the current regulatory framework, in terms of allowing changes to the CAPEX programme during a regulatory period and/or trading off between OPEX and CAPEX solutions, would lead to better outcomes for users.

Degree of flexibility in the capital investment plan

- 4.3.3 The Capital Investment Plan (CIP) is a key input into the periodic review process presenting all anticipated capital projects over the next control period. The capital planning process is a significant undertaking, taking approximately 18 months to develop a list of hundreds of projects based on a range of project drivers. Projects are grouped into two categories: the core programme and the capacity development programme.³¹
- 4.3.4 All projects in the final CIP are subject to the formal user consultation process, involving the description of the project deliverables, outline of the business case for the project and why it is in the interests of users. This is a costly and time-consuming process for all involved (the latest CIP was a 543 page document, with the process including face to face consultation representing a total of 28 hours of meetings, with 26 attendees from 8 airlines). This clearly demonstrates that a significant amount of time is spent on preparing and consulting on information for expenditure which is largely non-discretionary (e.g. key maintenance activities). This process would be

³¹ Projects in the core programme are focused on critical capital maintenance, replacing end of life assets, complying with safety and environmental standards, and upgrading to the latest technologies and developed through developed through a 'bottom up' process focused on asset need using a systemised, risk-based approach to capex prioritisation, in accordance with ISO 55001 asset management standards. Capacity development projects are large scale strategic infrastructure projects intended to facilitate growth across the business.

significantly enhanced by focusing on the 'discretionary' elements of the investment programme, namely the enhancement projects that are typically the focus of airline interest.

- 4.3.5 There is often significant uncertainty both around the efficient level of CAPEX and the particular projects that might be required over the next five-year period as part of setting the CIP. For example, circumstances may change such that capital investment included in the price settlement is no longer needed. These issues are likely to be exacerbated when there is uncertainty in the industry, as is likely to be the case for the next several years.
- 4.3.6 In recent years, regulators have acknowledged that agreeing investment plans for a number of years in the future at the time of the price review is a restrictive approach and does not reflect uncertainty around CAPEX needs and the costs of CAPEX programmes over the regulatory period. For example, as explained in section 2, in 2014 the CAA changed the regulatory approach at Gatwick from a traditional price cap to a commitments based approach.³² Within the commitments based approach, the CAA sets an annual minimum investment commitment that Gatwick must reach or exceed in order to meet its obligations to maintain and develop the airport infrastructure in line with service quality targets.³³ The capital plan does not include commitments to deliver specific outputs beyond those encompassed by service quality requirements, and Gatwick Airport is not subject to triggers in the price cap linked to the delivery of specific investment projects. It therefore has flexibility to adapt its investment programme in response to changes in market conditions or new opportunities to improve services for passengers.³⁴
- 4.3.7 At other airports, such as Brussels Airport, rather than engaging with users on each individual CAPEX project, discussion is focused on the largest CAPEX projects, which together represent a significant proportion of the overall capital investment programme at the airport.
- 4.3.8 Even at Heathrow Airport, the CAA has recognised that agreeing investment plans at the time of the price review for the next five or six years can be difficult given the uncertainty regarding cost forecasts.³⁵ It therefore set an initial CAPEX envelope for

³² CAA (2016), 'Economic regulation: A review of Gatwick Airport Limited's commitments framework Findings and conclusions' CAP 1502 p26 paragraph 3.5

³³ CAA (2016), 'Economic regulation: A review of Gatwick Airport Limited's commitments framework Findings and conclusions' CAP 1502 p25 paragraph 3.1

³⁴ CAA (2016), 'Economic regulation: A review of Gatwick Airport Limited's commitments framework Findings and conclusions' CAP 1502 p25 paragraph 3.1 In Q5, running from 2014 – 2021, the minimum investment commitment was set at £100 million per year. In 2016, it was increased to £120 million in line with inflation

³⁵ Economic regulation at Heathrow from April 2014: final proposals, p80 paragraph 5.2

Q6 comprising a fixed allowance for core CAPEX,³⁶ and an indicative allowance for development CAPEX.³⁷ Cost allowances for individual development projects are fixed within period which allows the price control to be flexible to the emerging CAPEX needs of the airport and users.³⁸

- 4.3.9 Increasing flexibility in the capital planning process, by making it easier for the airport and airlines to agree on significant new investments required, and for these to potentially change within a control period as requirements change, would be beneficial for Dublin and the users of the airport.
- 4.3.10 We would propose that based on consultation with users, an annual amount of CAPEX could be set for Dublin Airport to undertake core capital projects without the need for project-level consultation. We think that this would be particularly relevant for costs such as routine and maintenance CAPEX, where costs are typically less substantial and easier to forecast. Consultation would instead be centred on significant enhancements and commercial projects, which would reduce the administrative burden on all parties while ensuring focus is on the key aspects where there is benefit from engagement between users and the airport. This could use a format similar to the StageGate process introduced by the Commission as part of the 2019 Determination.

4.4 The Regulatory Till

- 4.4.1 Dublin Airport is subject to a single-till regime. The Commission defines eight categories of commercial revenue included in the till: retail; car parking; property rents; property concessions; lounges, fast track and platinum services; US preclearance; property advertising; and other.³⁹ The only commercial activities which are not included in the till are new investments where users do not share Dublin Airport's confidence.⁴⁰ For these projects, Dublin Airport assumes all risks from proceeding with a project and the costs and revenues are excluded from the till.

³⁶ Core CAPEX project is any project that has reached Gateway 3, being taken forward for implementation following consultation in accordance with the governance arrangements.

³⁷ Development CAPEX project is any project under development that has not reached Gateway 3 in accordance with the governance arrangements, but for which an allowance has been included in the development CAPEX allowance.

³⁸ Economic regulation at Heathrow from April 2014: final proposals, p80 paragraph 5.3. For the upcoming regulatory period, H7, the CAA has proposed some changes to the details of the CIP regime, however, intends to retain the differential treatment of core CAPEX and development CAPEX.

³⁹ CAR (2019), 'Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024 Commission Paper 8/2019 24 October, p79 Table 7.3

⁴⁰ CAR (2014), 'Maximum Level of Airport Charges at Dublin Airport 2014 Determination Commission Paper 2/2014 7 October, p34 paragraph 3.3

- 4.4.2 In the 2019 Determination the Commission decided to continue with a single-till approach.⁴¹ The Commission stated that commercial revenues should be taken into account when setting a cap on aeronautical charges given the demand complementarities between aeronautical and commercial activities.⁴²
- 4.4.3 A number of European airports have moved from single to dual till regimes over the last few price reviews, including Aena and Brussels Airport. For example, Brussels Airport shifted from a single to a dual till regime over multiple control periods based on a comparison of Brussels Airport's tariffs to tariffs at a set of comparator airports. If Brussels Airport's tariffs were more expensive than the average of the four comparators with the highest tariffs, then the shift to a dual till was slowed. In contrast, if the airport's tariffs were lower than the average of the four comparator airports with the cheapest tariffs, then the extent to which commercial revenues were netted off aeronautical revenues was reduced. Dual till regimes are also used at Italian airports and airports in Australia and New Zealand.
- 4.4.4 A number of airports have also moved from single till to hybrid till regimes. A hybrid till regime considers which activities / revenues should be included in the till, and/or the extent to which commercial profits should be shared between the airport and users. In principle, there are two main types of hybrid till regimes, as follows:
- a) **Revenue-sharing arrangement:** in this hybrid-till approach, some of the economic profits generated by non-aeronautical services are used to recover the costs of providing aeronautical services. For example, at Copenhagen Airport between 30% and 50% of commercial revenue is included in the regulatory till. At Amsterdam Schiphol there is a 'voluntary contribution' to the regulatory till that is determined at the beginning of the year by the shareholder (the Dutch Finance Ministry).
 - b) **Limited regulatory domain:** in this approach some commercial activities are excluded from the till entirely, typically because they are provided in a competitive market or because they are not essential to the operation of the aeronautical business. For example, at AdP in 2017, the French government put in place a modified till such that only car parking remains in the regulated perimeter. It was considered that the hybrid till would motivate AdP to continue to undertake efforts with regard to retail activities, thereby promoting customer satisfaction.

⁴¹ CAR (2010), 'Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024 Commission Paper 8/2019, October p44 paragraph 4.17

⁴² CAR (2014), 'Maximum Level of Airport Charges at Dublin Airport 2014 Determination Commission Paper 2/2014' 7 October, p36 paragraph 3.16

4.4.5 There are a number of benefits associated with a hybrid till approach such that the Commission should consider this approach for the next regulatory period:

- a) **Effect on charges.** One of the most frequent arguments put forward in favour of a single till is that it is reasonable that profits generated by airports in commercial activities are used to reduce the charges paid by airlines as airlines provide the passengers at airports. However, this is a simplistic argument; airlines do not have control over commercial activities at the airport and do not undertake any innovations to grow non-aeronautical income. Additionally, even in a dual- or hybrid-till regime, airports may use revenues from non-aeronautical activities to reduce costs for airlines in other ways than through lower charges. For instance, profits from non-aeronautical activities may be reinvested in airport infrastructure, reducing the airport's capital needs.
- b) **Economic efficiency.** The Commission justifies the use of a single till due to demand complementarities between Dublin Airport's commercial and aeronautical activities. Aeronautical and commercial services are unlikely to be perfectly complementary and an increase/decrease in aeronautical prices are unlikely to have a material effect on commercial spend. However, while these services are not perfectly complementary, there are likely to be some demand dependencies between the two. A hybrid-till regime may therefore be optimal in terms of economic efficiency; it allows an airport to use some of its profits from non-aeronautical activities to contribute to costs of aeronautical services—those for which there is a clear direction of causation from aeronautical activity to non-aeronautical income—without the complete cross-subsidy required under a single-till regime.
- c) **Market power in commercial activities.** One argument for the use of a single till is if an airport has market power in commercial activities, commercial costs and revenue should be included in the price cap calculation. However, the presence of market power does not mean that an airport can exercise it. For example, market power in car parking implies an airport would not build additional car parking facilities even if there is sufficient space to do so and if users' willingness to pay justifies such an investment. In contrast, airports' incentives often point in the opposite direction, to develop the maximum amount of available space for commercial services.⁴³ We face competitive constraints for a number of our commercial activities—in particular, long-term car parking and landside commercial property. We therefore consider that these activities could be excluded from the regulatory till.
- d) **Financial viability.** A hybrid till can be seen as a device to build up capital reserves to help to fund major investment projects. Indeed, there is precedent for this argument in the USA, where airports with dual-till regimes (or 'compensatory' approaches, as

⁴³ CAA (2000), 'The 'Single Till' and the 'Dual Till' Approach to the Price Regulation of Airports'. Consultation paper, December.

they are called in the USA) such as New York used their retained commercial revenues to build up capital reserves, which in turn were used to provide debt service cover. With the current single-till regime, Dublin Airport does not have this capacity. A hybrid till would provide increased incentives for the airport to develop its commercial activities while also protecting and ensuring the financial viability of the airport going forward through a greater retention of its commercial earnings.

- 4.4.6 There are therefore significant benefits of moving away from a single-till regime, while still maintaining some cross-subsidisation between commercial and aeronautical activities. Practically in moving to a hybrid till, there are two factors that are important to consider: ensuring it does not increase the administrative burden and timing.
- 4.4.7 Indeed, one of the commonly identified advantages of the single till is that it is relatively straightforward to administer since it does not require cost allocation between aeronautical and commercial services. Under a dual or a hybrid till, it may be necessary to define the activities that the regulated till would cover, in order to determine which costs and revenues should be taken into account when setting the price cap. This may be straightforward for some activities, but there are many common costs between aeronautical and commercial services, and judgements need to be made to allocate these costs to a particular till. This was a reason used by the Commission for not adopting a dual-till regime for Dublin Airport in 2011, as the Commission determined that it would not have the required detailed cost-allocation information.⁴⁴ For instance, it is not clear whether the lighting and heating costs of a walkway that leads to both a boarding gate and to retail outlets should be allocated to the aeronautical or commercial till.
- 4.4.8 For this reason, we consider that it may be more appropriate to move to a hybrid till based on a revenue-sharing arrangement where a certain proportion of commercial revenue is netted off from charges each year. The proportion of commercial revenue retained in the till could be defined in advance or it could vary depending on, for example, a comparison of Dublin Airport's charges with those of comparator airports. In addition, rather than shifting to a certain revenue-sharing percentage all at once, the Commission could consider progressively reducing the cross-subsidisation over time.
- 4.4.9 We believe that this may now be an opportune time to introduce this revenue -sharing arrangement given that it is apparent that the impact of COVID-19 means that there will be a significantly increased risk across a number of the commercial activities that the airport is involved in, which is totally separate to volume risk, therefore airports

⁴⁴ Commission for Aviation Regulation (2012), 'Future investments and the regulatory till.'

need more freedom for making investment decisions in this enhanced risk environment.

4.5 Price cap compliance

4.5.1 COVID-19 has led to a significant reduction in passenger traffic. However, at the same time, cargo operations have been higher than expected and movements have not declined by as much as passenger traffic (i.e. load factors have significantly declined). These impacts mean that based on the menu of charges that was set in advance of COVID-19, the price cap per passenger has been exceeded even as total revenue has been substantially lower than in the 2019 determination. In order to be compliant with the price cap, we would have to lower charges elsewhere, which would be further financially damaging in the current situation.

4.5.2 It is also going to be very difficult for us to accurately estimate passenger and cargo traffic going forward to support the calculation of the charges menu over the coming years. Therefore, it is difficult to determine the charges that will deliver the maximum aeronautical revenue per passenger outcome.

4.5.3 To help mitigate these challenges, we consider that there are some potential approaches that the Commission could take going forward:

- Cargo could be removed from the price cap altogether. Given that cargo typically makes up only 2% of all traffic at the airport (although this was significantly more during the height of the COVID-19 restrictions), this could be a proportionate approach to adopt going forward.
- Provide cargo flights a corresponding passenger unit, e.g. assume 1 passenger is equivalent to 100kg of freight handled, as part of a work load unit. A number of airports around the world charge on this basis. However, there is not a strong cost-based rationale for assuming that the cost of 1 passenger is equal to the cost of 100kg of cargo, particularly given that the resources used to produce output of passengers are typically very different from those used to generate cargo outputs.

4.6 Price control duration

4.6.1 The current regulatory framework at Dublin Airport has been based on five year cycles since regulation was introduced in 2001. In the 2014 final determination, the

Commission stated that a five year price control ‘seems to be a duration that strikes a reasonable balance between being too short or too long.’⁴⁵

- 4.6.2 As mentioned in response to the Commission’s consultation on the interim review,⁴⁶ we would not be in favour of shortening the current regulatory period to end in 2023 as proposed by the Commission.⁴⁷ Instead we would suggest potentially lengthening future price control periods to six or seven years, and would suggest lengthening the current regulatory determination period, potentially to 2026/27.⁴⁸
- 4.6.3 We consider that there are a number of benefits to longer price control periods, as follows:
- a) **Lower administrative burden.** Carrying out periodic reviews less frequently would reduce the administrative burden of the regulatory regime, and therefore costs to the airport and users. We note however that with a longer price control period, there may be greater need for more frequent interim reviews. It is important to ensure that interim reviews do not become ‘mini price reviews’ as this would negate the benefits of a lower administrative burden stemming from a longer price control period.
 - b) **Innovation and dynamic efficiency.** A longer price control period may encourage dynamic efficiency and allow Dublin Airport to focus efforts on the longer term efficiency of the airport.
 - c) **Tariff certainty.** A longer control period increases the period over which tariffs are fixed. This may allow airport users to better plan for the future, where there is greater certainty around prices and revenues.
- 4.6.4 Indeed, a number of regulators have implemented longer price control periods for these reasons. This includes changes made by the Water Industry Commission of Scotland (WICS) for Scottish Water, which was subject to four year price control periods prior to 2010. In 2010, the regulatory period was extended to five years, running from 2010 to 2015, and was then extended to six years for regulatory periods after 2015. WICS stated that the increase in the duration of the price control period would benefit customers in terms of greater certainty in bills and would allow Scottish Water to increase the efficiency with which it delivers outputs. It was felt that a longer

⁴⁵ CAR (2014), ‘Maximum Level of Airport Charges at Dublin Airport 2014 Determination’, Commission Paper 2/2014 7 October.

⁴⁶ CAR (2020), ‘COVID-19 Price Regulation Response Airport Charges – Dublin Airport Commission Paper 3/2020, 30 June .

⁴⁷ Dublin Airport (2020), ‘Response to Commission for Aviation Regulation COVID-19 price-regulation response’, 18 August, p. 19.

⁴⁸ Dublin Airport (2020), ‘Response to Commission for Aviation Regulation COVID-19 price-regulation response’, 18 August, p. 19.

price control period would also improve WICS' ability to monitor the performance of Scottish Water and hold it accountable appropriately.⁴⁹ In addition, one of the benefits the CAA cited when moving to the new commitments regime at Gatwick was the benefit that the price commitment would be locked in for longer than a traditional (five-year) price control, with commitments set for seven years.

4.6.5 However, given the uncertainty that can arise over the course of a price control period, and particularly in the current environment, we consider that a longer price control period should only be implemented in tandem with a move to allow more flexibility as part of the price control period. For example, in 2013, for RIIO-1, Ofgem moved to eight year price control periods for gas and electricity transmission and distribution. This was introduced alongside a mid-term review of outputs halfway through the eight year period. However, as part of setting the RIIO-2 price control, Ofgem has noted that 'the uncertainty surrounding network activity in the future makes it difficult to predict the allowances necessary for a range of different activities. We think that this risk is too high to justify retaining the current arrangements of setting price controls for eight years.'⁵⁰

4.6.6 Ofgem has, however, allowed for some flexibility in the duration of the RIIO-2 price control period. While the default length of price control is set at five years, if networks make a compelling case for setting allowances for activities, projects or programmes over timescale longer than five years, such as on innovation or efficiency grounds, Ofgem considers a multi-track arrangement (i.e. setting some allowances for five years and some for longer). For this to be justified, evidence must be presented of significant net benefits to consumers relative to a five-year period.⁵¹ This may allow for higher efficiencies from companies being able to plan for the longer-term.

4.7 Regulated Entity Recapitalisation

4.7.1 COVID-19 has led to a sharp reduction in traffic at Dublin Airport and significant losses in aeronautical and commercial revenue. Dublin Airport is expected to substantially underperform against the 2020 and 2021 volume targets. It is expected that our revenue loss will be substantial in these two years and we will therefore fall well short of earning the allowed rate of return (of 4.2% real) on our regulated assets.

4.7.2 While the RAB model does not provide a guarantee that the company will earn the allowed return, regulatory financing duties are typically interpreted as requiring

⁴⁹ WICS (2009), 'The Strategic Review of Charges 2010-14: The Draft Determination, p3.

⁵⁰ Ofgem (2018), 'RIIO-2: Framework decision', paragraph 3.1.

⁵¹ Ofgem (2018), 'RIIO-2: Framework decision', paragraph 3.6

regulators to seek to ensure that an efficiently operated company will, on average, earn a fair rate of return on its capital investment. The scale of the COVID-19 revenue impact raises a question around our ability to earn a fair return on the assets in the RAB. If we are expected to bear the full revenue impact of the COVID-19 pandemic, there are likely to be important consequences for our longer-term investment prospects and how debt (and potential equity) providers assess the risk of the business.

- 4.7.3 At the heart of this issue is that regulatory depreciation will continue to be deducted from the RAB at a time when we are unable to earn revenues that are commensurate with this depreciation.
- 4.7.4 One way to address this issue would be through making a future adjustment to the RAB to allow for the recovery of the revenue shortfall over time. Without adjustments to the RAB, in order to offset the revenue reduction in 2020/21, Dublin Airport would either need to reduce its costs or increase charges significantly. Neither of these options is feasible in practice. A cost saving of this scale is not possible given the proportion of the cost base that is fixed. Similarly, increasing tariffs to the extent required to allow full revenue recovery would lead to a price that the market is unable to bear.
- 4.7.5 The price path could be smoothed, without requiring Dublin Airport to fully write-off cost recovery, by making a RAB adjustment. This could involve capitalising a proportion of the revenue under-recoveries and recovering them through additional depreciation and return in subsequent control periods (effectively extending the recapitalisation over a 10 to 12-year period). This entails treating these exceptional deviations similar to the introduction of a new asset to the capital base and allows for recovery over a typical asset life. An alternative approach, which would achieve a similar purpose, would be to implement a 'depreciation holiday' in 2020 and 2021 such that the value of 'unfunded' regulatory depreciation would not be deducted from the asset base in these years. The revenue requirement would increase in future regulatory periods to allow Dublin Airport to recover these shortfalls.
- 4.7.6 The capitalisation of under-recoveries has been used in the context of the development of the Northern Ireland gas distribution network, in the form of a 'profile adjustment', and is an extension of the approach used in many regulatory frameworks to deal with under-recoveries that arise from pricing below the cap. Further detail on the adjustment undertaken in Northern Ireland is included below.

Northern Ireland Gas Distribution Network

- 4.7.7 As part of the 2014-2016 regulatory framework for Northern Ireland's gas distribution networks, the Utility Regulator introduced a mechanism to smooth the price path over time, known as a Profile Adjustment.⁵² The mechanism has been retained for the 2017-2022 price control period.⁵³
- 4.7.8 The profile adjustment allows revenue to be carried forward to future years to maintain an even price profile over time. The recovery of this deferred revenue is secured for the regulated company by way of an addition to the regulatory asset base. The profile adjustment builds up over the course of each price control period, and then forms part of the asset base at the beginning of successive reviews.
- 4.7.9 This approach was adopted to ensure that charges are not unduly high in the early phases of the gas market's development and to encourage the continued growth of the gas market. Deferred revenues are capitalised and added to the regulatory asset base and recovered in later years when the customer base and market volumes are likely to be higher. This ensures that customers over different generations pay the same price for gas, and that customers in earlier years do not bear a greater proportion of costs of development of the gas market.
- 4.7.10 This approach would provide Dublin Airport with full remuneration on its assets over the longer term, including the recovery of financial losses arising from the impact of COVID-19, while smoothing the path of the price cap in the short to medium term and avoiding large spikes in charges. A smoothed price path balances cost recovery for the airport and the impact on user charges.
- 4.7.11 The regulatory framework at Dublin Airport already adjusts for some under-collection of aeronautical revenues through the K factor. The K factor operates with a two year lag and allows under-recovery of aeronautical revenue to be carried forward with a limit at 5% of the price cap.⁵⁴ The K factor is de-risked in relation to volume meaning that Dublin Airport recovers exactly the amount intended with no variation due to differences in passenger numbers.⁵⁵ However, in its Interim Review of the 2019 Determination, the Commission stated that it intends to remove the K-Factor from the 2022 price cap formula, meaning no under-collection from 2020 would or could be

⁵² Utility Regulator (2013), 'GD14 Price Control for Northern Ireland's Gas Distribution Networks for 2014-2016 GD14 Final Determination', December.

⁵³ Utility Regulator (2016), 'Price Control for Northern Ireland's Gas Distribution Networks GD17 Final Determination'.

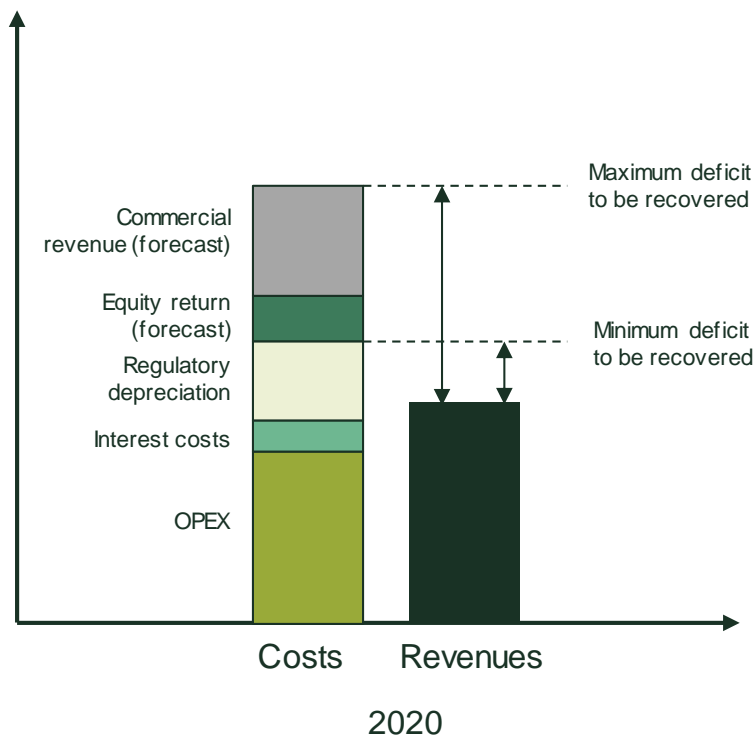
⁵⁴ Except where the application of the OPEX passthrough term would lead to under-collection higher than 5%. CAR (2019) 'Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024', p71.

⁵⁵ CAR (2019) 'Determination on the Maximum Level of Airport Charges at Dublin Airport 2020-2024', p71.

carried forward.⁵⁶ Therefore, allowing Dublin Airport to recover the revenue shortfall due to COVID-19 through adjustments to the RAB is even more necessary.

- 4.7.12 There are a number of design aspects to consider as part of this approach.
- what is the size of the RAB adjustment—e.g. what proportion of the revenue shortfall does Dublin Airport bear and what proportion is it allowed to recover in future periods. One potential approach to calculating this would be to base the adjustment on the amount of forecast regulatory depreciation in 2020 and 2021 that we are unable to recover through charges. This would be calculated as the delta between: i) forecast regulatory depreciation and ii) revenue minus (operating costs plus interest payments). We consider that this value should act as the lower bound on the adjustment given that it indicates zero equity return. This is highlighted in Figure 1 below.
 - over what period should the revenue shortfall be depreciated? A longer depreciation period will reduce the impact on charges in the short run, but result in users paying for this under-recovery over a longer period.
 - when should the under-recoveries begin to be remunerated? Given the size of the under-recovery, under-recoveries are likely to need to be remunerated from 2022.
 - there is an infinite number of potential price paths that would allow Dublin Airport to recover the same revenues in Net Present Value-terms over a given time period. The choice of price path should balance: i) cash flow considerations for the airport; and ii) airline considerations around the timing of price increases.
- 4.7.13 We note that such an approach is currently under discussion for a number of airport operators across Europe, including Heathrow.

⁵⁶ CAR (2020) 'Draft Decision on an Interim Review of the 2019 Determination in relation to 2020 and 2021', p.9 paragraph 5.11.

FIGURE 1 RAB ADJUSTMENT ILLUSTRATIVE EXAMPLE

4.8 Conclusion

- 4.8.1 The current regulatory framework relies on being able to make reasonable forecasts of a number of different parameters for a multi-year period. While this is difficult even in normal circumstances, it is likely to be particularly difficult over the next several years as the industry recovers from COVID-19. We therefore consider that the Commission should consider changes that can be made to the current framework to enhance the flexibility offered in order to ensure the best outcomes are achieved for the airport and users.
- 4.8.2 In this chapter we have set out our initial views on some of the areas of the regulatory framework where there may be merit in alternative approaches being taken for the next review. We welcome further engagement with the Commission and airport users on these and other areas of the regulatory framework going forward.

5. Next Steps

- 5.1.1 Just five months after the price control for the 2020 to 2024 period was set, and just three months after it began, the COVID-19 pandemic caused a significant downturn in passengers threatening the financial viability of Dublin Airport. As a result, the Commission initiated an interim review to consider the most appropriate regulatory framework for 2020 and 2021.
- 5.1.2 As the Commission has noted, it is important to start to think about the appropriate future regulatory framework that could apply from 2022; one which is more robust to the inevitable shocks and challenges that are likely to arise. We think that a fundamental review of the regulatory framework is merited and have set out our views on alternative regulatory frameworks, as well as changes in the regulatory building blocks that we think would lead to better outcomes for all stakeholders going forward.
- 5.1.3 We strongly believe in the merits of implementing a shadow price cap with negotiated contracts approach or alternatively a price monitoring regulatory oversight arrangement as our preferred approach, as detailed in chapter 3.
- 5.1.4 Should the Commission decide to retain the current price cap, building block approach, it is critical that both short-term and long-term modifications be considered and implemented to improve the application and fundamental workings of the current regulatory regime, as outlined in Chapter 4.
- 5.1.5 We would welcome further discussion with the Commission on these matters.