IATA submission to the Commission for Aviation Regulation

“Maximum Level of Airport charges at Dublin Airport 2020-24 Draft Determination”

Introduction

The International Air Transport Association (IATA) welcomes the opportunity to provide comments on the Commission for Aviation Regulation (CAR) 2020-2024 Draft Determination for Dublin Airport.

Overall, we welcome the CAR’s draft determination proposals of a 15% reduction in the real price cap per passenger on the first year of the regulatory period, and the followed by constant real charges throughout the remaining years of the period. We note that such determination has been reached based on detailed and robust analysis of each of the building blocks and the consequent setting of challenging, yet achievable targets.

It is no surprise then, that faced with an effective challenge, that a monopoly airport like Dublin negatively reacts to such determination with threats to stand down works and revaluate the delivery the much-needed capital expenditure program. We urge the CAR to stand firm and continue with the approach it has taken so far and make a final determination in line with its duties.

If at all, there appears to be areas in which we believe that the CAR may have been too conservative in its approach, which will be highlighted throughout this submission. Our comments below follow the same structure as that of the Draft Determination, and would appreciate for the CAR to take them into account before making its final determination.

Approach to regulation

- We support general approach to regulation, which implies the setting of price caps for a 5-year period, using a building block approach on a single till basis. Comments on CAR’s assumptions on each of the building blocks are made in the following subsections.
- We support CAR’s current approach of allocating risks (upside & downside) on outturns differing from CAR’s forecasts on passenger numbers, operating costs, commercial revenues and cost of capital to DUB on the basis that it is the party best able to manage them.
- We support the elimination of rolling incentives (opex & revenues) since it is unclear whether they really have an incentivising effect as well as past difficulties in determining whether deviations from forecasts where due to efficiency-related matters or other reasons.
- We remain sceptical about the need to bring forward regulatory depreciation on the basis of financial viability since it is still unclear whether it is actually needed.

Passenger forecast

- We remain supportive of the CAR developing its own independent model, given the inherent perverse incentives that exist when an airport has the volume risk and defines its own traffic forecast. The proposed traffic forecast figures appear to be reasonable.

- We would appreciate for the CAR to advise whether it has sought individual inputs from at least the largest airlines in the making of its traffic forecasts (usually top down traffic forecasts are complemented by bottom up adjustments based on inputs from stakeholders).

Operating costs

- We remain fully supportive of the way that the CAR has conducted the operating cost efficiency analysis. In particular, seeking external advice to determine an efficient level of opex, and then determining opex targets on the basis of such efficiency analysis.

- The analysis provided by CEPA/Tailor Airey is thorough and its conclusions are welcome. Users would not have been able to retrieve such detailed information on a regular consultation. We would only like to comment regarding security costs, in which efficiencies are based on better rostering & throughput improvements (indicated by Dublin airport), and wondered whether the consultants have also considered the implementation of best practices at other airports to further improve the security passenger throughput at the airport.

Commercial revenues

We are broadly in agreement with the commercial revenue forecasts in the determination. Still, we would appreciate for the CAR to take notice of the following observations before making its final decision:

- We are supportive of the use of elasticities (and relevant uplifts) for the calculation of commercial revenues. The only concern is that the current calculations are based on DAA's own past performance (and therefore the underlying assumption is that the airport is efficient in the generation of commercial revenues) . We would appreciate for the CAR to consider whether it would be prudent to seek external advice to determine if DAA could improve its commercial offering and increase its commercial revenue (beyond the historic elasticity and the one off uplifts being already considered).

- Some of the elasticity calculations have changed between regulatory periods (e.g.. the elasticity for retail changed from 0.67 to 1.1). While the latest elasticity assumptions are much more intuitive, it would be appropriate for the CAR to further analyse and explain what drove such changes.

- On the lounge, fast track Platinum services, the CAR mentions that elasticity calculations are unreliable due to the exponential growth in revenues from this stream. It may be prudent for the CAR to further analyse why such increase happened in the first place and why it could not happen again.

- As commented in our response to the Issues paper, we do not believe that the US pre-clearance should be treated as a commercial activity (in which its revenues should be maximized). Instead, we suggest it is treated as a regulated activity.

Cost of capital

We support the general approach of calculating the cost of capital based on the weighted cost of capital methodology as well as using the CAPM model for calculating the cost of equity. We also agree that there is enough evidence to justify a cost of capital lower than is much lower than that applied in the last determination. However, there is reason to believe that the CAR may have been too conservative in its calculations and allowed a cost of capital higher than what it should. Our specific comments are highlighted below:

- Risk free rate:
    - The risk-free rate methodology is reasonable. We note, however, that the yield on Irish government bonds has shown a steady decline since the finalization of the Swiss economics report (which expected a move in the opposite direction). We also note that the ECB recently announced the postponement of increases in interest rates. In this regard, the CAR may need to review the RFR ranges considered for its Final determination.
    - If an uplift in the RFR is still considered in the Final Determination as a conservative measure, the CAR should be careful of erring into a double compensation, by also including an "aiming up" adjustment.
- TMR
    - We are unsupportive of the usage of the TMR approach, as it does not seem very logical to expect the same returns for an investment if interest rates are lowering. While this is being applied in the UK, it does not seem to be the approach applied elsewhere in Europe (normally, the ERP approach has been used).

- o We support the usage of the geometric mean for either ERP/TMR approaches, particularly as we are dealing with a price setting period of 5 years (as clearly set out by Damodaran[1]. In this context, and while we see that there may be case to choose a point between the geometric and arithmetic averages, we see that Blume average method applied by Swiss Economics shows too much bias towards the arithmetic average. We therefore request the CAR to reconsider such averaging method.
    - o It is unclear whether the results shown in table 11 are nominal or real. Would appreciate for a confirmation on this matter.
- Asset Beta
    - o We support the approach on determining the beta for DUB based on betas of listed companies and other relevant regulatory decisions. We are also in agreement against the usage of the Blume adjustment as it is not relevant for this analysis and artificially increases the resulting betas.
    - o However, in the selection of airports it may be prudent to follow the Thessaloniki forum advise to focus on airports within the region.
- Cost of Debt
    - o It is difficult to comment on embedded debt figures, since all figures have been redacted. We do note, however, that the latest yield of the DAA's 2016 emission is 0.9% (nominal).
    - o The uptick calculations may need to be revised based on potential updates on the RFR section.
    - o It should be noted that despite DAA's current A- rating, CAR assumes a cost of debt of a notional company with a BBB rating (i.e. more expensive), being one of the arguments the increased level of investment. If an aiming up is later used because of the level of investments, then there appears to be an issue of double counting.
- Aiming up
    - o We see that the CAR's main objective of applying an aiming up adjustment is as a precaution to not underestimate the WACC, especially in the context of a significant capital expenditure. However, the ranges built for the individual parameters already include uplift adjustments which can also be considered as a precaution. Assuming future increases in the risk-free rate, assuming a notional BBB rating precisely because of the capital expenditure program, applying a TMR approach (instead of the ERP) which increases the CoC calculations in the context of relatively lower risk free rates, are all examples of uplifts included in the ranges. In this regard, we support the usage of the mid-point of the range rather than applying aiming up factor.

Capital expenditure

IATA endorses the CIP 2020 initiatives particularly the increase in stands and piers, and other terminal improvements that enhance terminal efficiency and the passenger experience. The analysis of CAR and Helios indicates that the planned investments are suitable for achieving a 40 million passenger capacity and are largely aligned with airline requirements.

Specific IATA observations on individual initiatives include:

- CIP .20.03.020 Terminal 2 Check-in Area Optimisation: Concur with the CAR's acceptance of DAA's plans to reconfigure the T2 check-in hall and the introduction of additional desks and self-service. It should be kept in mind; however, that airlines will still need to be informed of the costs for moving to CUSS and whether there will be any changes in airline allocation to optimise the use of the space.

- CIP .20.03.028 Terminal 2 Early Bag Store & Transfer Lines: Agree with CAR's finding with regards to Early Bag Storage (EBS). This is a critical project if DUB is to avoid bottlenecks particularly as US Preclearance traffic increases. In light of the expected increase in transfer traffic (which is already occurring) IATA agrees that it is prudent to include the intra-terminal transfer belt in CIP 2020-2024.

- CIP .20.03.051B West Apron Underpass Pier 3: IATA agrees with the objective to open up the west of the airfield by means of an underpass tunnel, however further analysis and engagement with airlines is required to determine

[1] "*...There are, however, strong arguments that can be made for the use of geometric averages. First, empirical studies seem to indicate that returns on stocks are negatively correlated over time. Consequently, the arithmetic average return is likely to overstate the premium. Second, while asset pricing models may be single period models, the use of these models to get expected returns over long periods (such as five or ten years) suggests that the estimation period may be much longer than a year. In this context, the argument for geometric average premiums becomes stronger...* " (Damodaran, Equity Risk Premiums (ERP) – 2018 Edition)

the most appropriate location of the underpass on the basis of operational efficiency, use of South Apron as Hub, future pier developments and impact on aircraft stands.

- CIP .20.03.045 New West Satellite Pier including Airfield: IATA notes that this initiative is not discussed in CAR's determination and assumes it has been deferred or dropped. During DAA's consultation, IATA had raised concern about the cost and timing of this initiative.

CIP 2020 Review Process

IATA agrees that a more dynamic process to review the progress of the CIP 2020 initiatives should be put in place. This is important in light of the size of the investments being made and the need to assess whether adjustments are required once designs and costing become more certain. This will help ensure that business cases for major infrastructure initiatives remain robust.

IATA believes that requiring DAA to report on the delivery of projects against CIP 2020 timelines as they successfully for the PACE projects is a good start but believes that the Option 4 'Stage Gate' approach will provide the best solution for tracking major project expenditures during the five-year period.

The use of an Independent Fund Surveyor (IFS), accountable to all parties, will provide a useful analytical resource. The adoption of a structured stage gate process will bring greater accountability and permit the more flexible management of projects. Providing airlines with more the opportunity to be engaged should result in a better project outcome and build greater support for investments.

The criteria for determining what projects should be considered under this process is a balance between benefits of such a dynamic review versus the costs and added complication of putting an IFS in place. CAR's suggestion of including strategic importance or that exceed a €20 million threshold seems reasonable; however, a common understanding of what is strategic will need to be worked out.

Adopting a lighter four phase Stage Gate process for Dublin would realise many of the benefits of dynamic consultation while keeping the added complexity and cost to a manageable level.

Capex/depreciation modelling

In addition to the above we would like to address certain financial modelling assumptions regarding capex, depreciation and RAB adjustments:

- The CAR is assuming constant amounts of capital expenditure per year over the regulatory period (EUR 410m) and adjusts the building blocks (depreciation & cost of capital) on the basis of such profile. If the capital expenditure is delivered later than expected (i.e. a backend loaded program), this implies that the airport would have received an allowance during the period for an asset that was not delivered in time. Taking into account that the level of capex is significantly larger than in previous periods, there is potential of ending up with a large amount unnecessary allowances (in the unwanted scenario where capex slips). Since the CAR currently only clawbacks when a project has not been delivered (and not when the timing of the delivery is misaligned), it may need to reconsider such an approach given the current circumstances.

- The CAR financial model calculates annuity allowances (depreciation + cost of capital) as if capex was delivered at on the first day of the year. This oversimplification unnecessarily increases the building block costs (and therefore, charges). It is recommended that averages are used instead.

- Linked to the above, there are usually long building times for large capital investment projects, and therefore assuming an annuity (which includes an element of depreciation) based on capex for assets that are still "work in progress" and not on "in use" could lead to a significant element of prefunding. We suggest for the CAR to review its assumptions.

- We see that the opening RAB was adjusted for EUR 2.1m as a clawback of allowed cost of capital due to undelivered capex. We wondered why only the cost of capital was considered for the clawback amount and not also the related allowed depreciation (i.e. the annuity).

- The depreciation of the Opening RAB (excluding new capex & trigger items & adjustments) is "hardcoded" in the financial model (worksheet "Opening RAB Calcs", row 45). We would appreciate if the CAR could further explain how these numbers were calculated.

Quality of Service

IATA supports the introduction of an expanded/improved set of Quality of Service measures. The enhanced set of objective measures encourage consistent and efficient airport operations. The new measures are more clearly defined and create a more direct link between the facilities/service the airport provides and the charges that airlines pay.

Other points regarding quality include:

- The change in security queue target to '70% below minutes' and 97% below '25 minutes' is better than the previous '100% under 30 minutes' but still does not meet the recommended target of 10-20 minutes per economy passenger that is classified as 'optimum' in IATA's Level of Service guidance.

- The timeliness and quality of assistance for Passengers with Reduced Mobility (PRM) in increasingly important. Tracking performance by the different types; arrivals, departures, pre-notified, and not pre-notified, is advisable in order to more quickly identify root causes for any problems.

- IATA agrees that the monitoring of the baggage handling system is best done in its entirety rather than belts only.

- Fixed Electrical Group Power (FEGP) is monitored at many airports and should be included as a performance measure for Dublin.

- The availability of passenger escalators, travellators and lifts are critical to the smooth functioning of the airport and are a good addition to the Dublin performance measures.

Financing, Risk and financial viability

While we see the purpose of reprofiling depreciation and support its usage on specific circumstances, we urge great care before using it. In the previous determination, the CAR brought forward some EUR 84m of depreciation which implied allowing for a higher level of charges than what should have been allowed had annuity depreciation been applied. Since traffic in the period was significantly above forecast, DAA had a significant benefit from that adjustment (since the amount kept from outperformance was higher than that would have been achieved without the adjustment).

For the 2020-24 period we see that the CAR is proposing to bring forward some EUR 133m of depreciation as a means to ensure that the airports' financials are in line with credit rating metrics and be financially sustainable. While we see why the CAR would want to do this, we are in disagreement about some of the assumptions utilized by the CAR that lead it to reach this conclusion. In particular:

- the assumption that DAA's shareholder does not make any capital injection (in other words, assuming equity would only have to be built based on returned earnings), and
- that DAA pays dividends over the period of around EUR 137m (noting that the depreciation amount brought forward is very similar, at EUR 133m)

We understand that there is significant capital expenditure forecast and understand that the CAR wants to ensure that DAA can finance such investment, but in the context of a significant capital expenditure it is hard to understand why the shareholder is not expected to inject capital (or at least forgo its dividends) until the capital expenditure program is delivered.

In any case, the CAR does not need to get into making dividend policy decisions (or to specifically allow more revenues so that it can distribute dividends). In its modelling what it needs to do is to calculate the financial ratios on the basis that the notional 50% gearing ratio will be maintained throughout the period (and leave it up to the shareholder how to deal with the equity portion of it).

In conclusion, we would appreciate for the CAR to revisit its forecasts and reassess whether bringing forward depreciation is really needed.

Other issues

- Incentives: We see that the CAR is proposing to treat incentives schemes under the cap so long as they are in line with the principles highlighted by the Thessaloniki forum paper on this subject. We also note that the CAR has indicated that these matters are to be discussed at the annual consultations, and therefore will bring the subject if necessary, during such meetings.

- K factor: We agree with the need to remove the volume risk in the calculation of the K factor and therefore support the selected option.

- Peak Pricing: We agree with CAR's view of not imposing any sub caps on differential charges (including peak pricing).

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