Aer Lingus Response to Airport Charges Issues Paper CP6/2008

INTRODUCTORY & SUMMARY

This paper contains Aer Lingus' response to the Commission's Issues Paper on the maximum Level of Airport Charges at Dublin Airport.

We note that most of the questions raised by the Commission relate to details of the process whereby the Commission calculates the building blocks of the next Price Cap. We have specific comments on these questions, but also feel that this is an important opportunity for Aer Lingus to highlight its wider concerns about pricing and efficiency at Dublin Airport. These points are picked up in detail in the individual methodology sections below. But to summarise, our key concerns are as follows:

- The Commission should adopt a long-term approach to calculating charges at Dublin, which would prevent charges oscillating unnecessarily in response to short run demand factors. This is important from the point of view of economically efficient airport pricing, but also reflects the reality that the airport, rather than airlines, is better placed to shoulder the impact of short-term economic downturns.
- In our view operations at Dublin are expensive and inefficient. The Commission needs to grasp this nettle in its determination by setting aeronautical charges that induce the DAA to improve drastically its performance.
- Capital investment at Dublin has also been very inefficient. There has been a lack of least cost long term, planning, which has culminated in the development of an over-specified and over-priced infrastructure. The Commission needs to address this in its Determination by applying strict efficiency criteria to the expenditure that is included in the RAB.
- Aer Lingus is also concerned that the determination could lead to an inappropriate *structure* of charges, regardless of the overall level of charges that the Commission sets. In particular, we are concerned about the views previously expressed by the CAR in relation to differential charging at T2 and DAA's policy for charging for check-in desk rentals at T2. These matters raise important regulatory principles.

Given these issues, we are further concerned with the timetable set out on p.3. It is unclear from this timetable whether airport users will have an adequate opportunity to respond to each of the key building blocks of the Price Cap.

Specifically, we note that the DAA is due to submit its investment plan in February 2009 and its "forecasts", we assume for passenger numbers, in March 2009. This raises several issues.

- First, we are concerned that the timetable does not clearly indicate the scope of the investment plan that DAA will submit. In particular, we feel it is essential that DAA's CIP is more than just a list of planned expenditure. Rather, the Plan needs to be accompanied by a clear business plan for DAA, which places the CIP in a meaningful context on which the airlines can comment.
- Secondly, given the importance of demand forecasts to the capital plan, we find it strange that DAA is scheduled to produce demand forecasts *after* the CIP. We consider that the demand forecasts need to be presented with the CIP or earlier in order for an informed debate on the CIP to take place.
- Thirdly, we are not clear that we will have an opportunity to comment on the CIP prior to publication of the Draft Determination. In our view this is not satisfactory, as too many decisions have already been made by the time the draft Determination is published. In our view the timetable needs to have time for interested parties to comment on the key regulatory building blocks *before* these are adopted into the Draft Determination.
- Finally, we note that the timetable does not explicitly include opportunities for interested parties to comment on other key building blocks, including the CAR's view of DAA's opex efficiency and the DAA's cost of capital. In our view these elements of the Price Cap also need to be subjected to scrutiny by interested parties before the Commission reaches its Draft Determination.
- The remainder of this response addresses each topic in turn as raised by the Commission. However, at the end of this submission we have included an additional section that addresses some particular concerns that Aer Lingus has, which are not covered under the headings of CP6/2008.

GENERAL APPROACH

On p. 7 of the consultation, the Commission raises the following questions:

- *Should the Commission continue with a CPI +/- X approach, using a single till, when setting the price cap?*
- *How should risk be treated? As stated in paragraph 2.13 above, the DAA currently bears all the risks, positive and negative, that the price cap is based on forecasts that turn out to be incorrect. Parties are asked to state if, and under what conditions, the Commission should deviate from this approach through 'clawbacks', ex post reimbursements to the firm or some other form of risk sharing.*
- *What should be the duration of the next determination? The Act requires that a cap last for a minimum of four years. Do parties consider four years appropriate, or would they prefer the cap to apply for a longer period?*

Summary of views

- Aer Lingus supports the continuation of a CPI +/- X approach, using a single till, when setting the price cap, but believes that the system as currently applied is too prone to medium term price fluctuations. Our view is that the Commission should adopt a longer-term approach to price-setting.
- We do not agree that the DAA bears *all* risks when then price cap proves to be incorrect. Rather it is our view that the commercial operations of airlines significantly insure DAA against the impact of downturns with the effect that airlines carry a significant part of the risk in the event that forecasts prove to be wrong. That is very clear in the current economic environment.
- Airports are a long term business and require a sufficient degree of long term certainty over their investments. In our view this is best addressed by a long term approach to price setting which balances costs and revenues over the life of the relevant investments, combined with five-yearly reviews to maintain efficiency incentives and to fine tune the level of the price cap to changes in long term expectations, rather than to short term fluctuations.

We set out our views in more detail below.

Detail

CPI =+/-X Regulation

The main strength of the CPI +/- X approach is that by fixing prices for a period of time the airport is given strong incentives to improve its efficiency provided those efficiencies are returned to customers through lower charges in a reasonable time frame. The RAB forms an integral part of this system by ensuring that over the medium to long term the airport operator is allowed to earn a reasonable return on its investment.

The most commonly cited weakness of the system is the inherent tendency for the regulated firm to reduce quality or levels of service in order to reduce costs, rather than achieve genuine efficiency improvements. It is well known that the regulator needs to carefully monitor opex and capex efficiency as well as levels of service. These issues are dealt with elsewhere in the consultation.

However, in the context of airport regulation the standard building blocks approach to CPI +/- X is further challenged by the long lived nature of the investments made in airport infrastructure and the large indivisible nature of those investments, e.g. runways, terminals and piers.

The consequence of this lumpiness in investment is that costs rise when new capacity is brought on stream, but because that capacity is inevitably underutilised in the first instance there is a tendency for prices to rise as a larger cost base is being spread over a number of passenger movements that has not yet increased to the same level.

This movement in prices is precisely the opposite of the movement you would expect to observe in a competitive market: prices should be expected to fall when there is excess capacity and rise when capacity becomes tight. This contrast is illustrated in Figure 1 below.

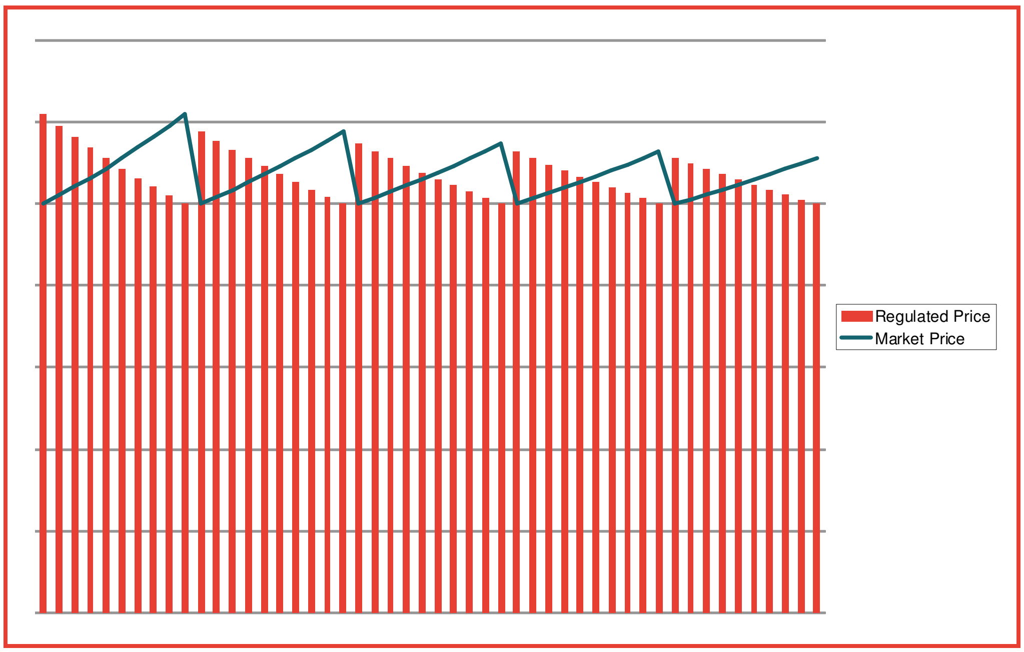

Figure 1: Illustration of contrast between market pricing for airport capacity and regulated short-term pricing, based on RAB

This tendency of the building blocks approach to lead to a saw tooth in prices that moves in the "wrong" direction is further exacerbated by fluctuations in demand resulting from changing economic conditions. In the event that passenger numbers fall as a result of an economic downturn the building blocks approach has a natural tendency to push up prices, because the cost base is spread over a temporarily lower number of passengers. This again is the opposite movement to that expected in a competitive environment, where weakness in demand conditions leads to reduced prices. This is the situation that Aer Lingus now finds itself in with respect to its own business.

These observations are important and not merely theoretical considerations in the current climate. As DAA develops T2 the cost base of Dublin Airport is scheduled to rise significantly. The cost base will increase still further if DAA is successful in developing the new runway that is in fact essential in order to take advantage of the new capacity at T2. Demand can be expected to grow in the medium to long term, but obviously with the World economy entering recession demand conditions are presently weak. All these factors suggest that efficient airport pricing should be low in the medium term, but the natural tendency of the building blocks approach to CPI +/-X may be to push airport charges up.

In our view, provided a sufficiently long-term approach is taken to calculating price limits there is no reason to expect significant movements in airport charges either as a result of capacity expansion or as a result of fluctuations in demand.

The Commission has to date partially addressed this issue by only allowing T2 expenditure into the RAB when T2 is operational (under the two box approach) and by deciding to calculate depreciation on T2 on a per-passenger basis. We will deal with the two box approach later in this submission.

As regards passenger based depreciation, the approach that the Commission has taken does not in our view go nearly far enough. To approximate to long run economically efficient pricing it is essential that the sum of depreciation and capital return be regulated on a per passenger basis, not merely the depreciation element. In this way total capital related costs are smoothed over time (rather like mortgage payments). By only addressing the depreciation element of capital costs the Commission is retaining an inverse saw tooth in pricing relating to the element of prices that relates to return on the RAB. That is not consistent with economic efficiency.

Furthermore, the Commission has only discussed applying passenger-based depreciation to T2. In our view this is inconsistent and unjustified in terms of economic efficiency which would suggest that per-passenger based capital charges should be applied to all long-term capital investments. It will certainly be essential to apply such charges to any prospective runway development. But there is no justification in not applying per-passenger based capital charges to all existing long-lived assets as well as to new investment.

There are, however, a number of different ways this concept could be applied. One way would be to calculate the per passenger charge that would recover the remaining value of the asset, including return on capital, over the asset's forecast remaining life, based on current demand forecasts. Applying this approach to the capital elements of airport costs would significantly reduce the variability of airport charges to either lumpy investment or to short run demand fluctuations.

Another approach would be to consider whether it is appropriate to treat assets like terminals and runways as having a specific finite life. While it is true they have an expected operational life, that life can expand or contract depending on commercial circumstances. Taking this view a short term down turn in passenger numbers should only lead to an increase in charges insofar as it slightly lengthens the period over which the airport recovers the cost of its investment.

Our view is that this sort of long term pricing is consistent with economic efficiency and provides more than adequate risk protection to the airport's investments because it embodies a *commitment* on the part of the Commission to allow the airport to recover a fair return on its investment in the long run (subject obviously to the requirements that the airport operates efficiently and provides a good standard of service).

The chart below contrasts how prices would be expected to move in response to a capacity expansion or a short term demand down turn under the existing building blocks approach and under the long term pricing arrangements that we consider would be more efficient.

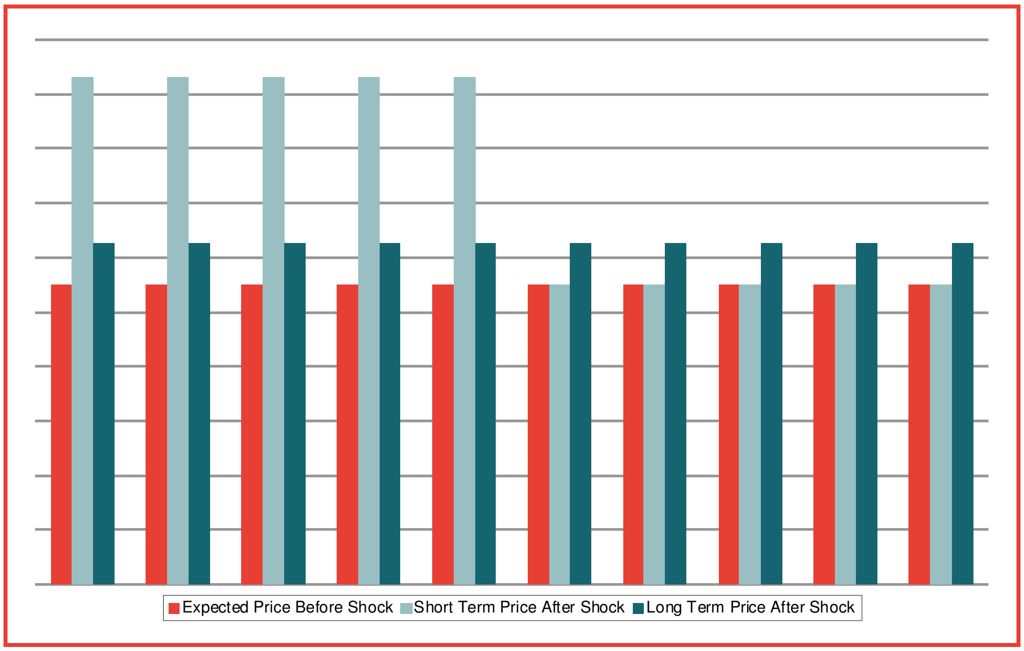

Figure 2: Illustration of different impact of demand shock on short term and long term pricing over 2 regulatory cycles

In this chart it is assumed that demand falls for one regulatory cycle as a result of an economic downturn, but then recovers to its previously predicted level. Under short term regulatory pricing, charges jump significantly above the level that was predicted before the demand shock. Under long term pricing the adjustment is much more modest, as the impact of any shortfall in predicted passenger numbers is recovered over the life of the investment, not over one regulatory cycle.

Risk

The Commission states that: "the DAA currently bears *all* the risks, positive and negative, that the price cap is based on forecasts that turn out to be incorrect" (emphasis added). Aer Lingus profoundly disagrees with this statement.

In an economic downturn companies in competitive markets see the prices they can charge fall. DAA is subject to no such pressure. The regulations as they currently exist allow DAA to maintain the same level of charges (or even increase charges) regardless of economic conditions. This in itself represents a significant protection from risk for the DAA.

Furthermore, the economics of airline operation also provide the airport with substantial insurance against the impact of an economic downturn. The overriding imperative on airlines is to maximise load factors in the short to medium term. As a consequence in conditions such as we are witnessing at the moment, airlines reduce ticket prices significantly to keep planes full. This is economically inevitable provided ticket prices still cover the short run variable cost of aircraft movement. There are no guarantees that ticket prices will cover the fixed cost of airline operations or the capital costs of aircraft leasing, etc. This is why many airlines suffer major financial difficulties in an economic downturn.

But the effect of airlines behaving in this way protects the airport from the worst effects of the downturn by maintaining passenger numbers. Thus airport revenues from airport charges are largely protected. While we accept that the airport is still exposed to commercial risk with respect to the amount of commercial non-aviation revenue generated per passenger, there is no argument for adjusting the price cap to reflect any such variations because these revenues are unregulated and DAA should bear their full commercial risk.

Adding any form of "risk sharing" that would allow the airport to raise charges if there were a shortfall in passenger numbers would be inappropriate because it would send the wrong economic signal in terms of the efficient pricing of airport services and would transfer more risk to the airlines which are in practice already bearing the largest part of the commercial risk in the overall economic activity at the airport.

Furthermore, if the Commission were to follow a long term approach to pricing as outlined above this would provide more than adequate protection to DAA by ensuring that it will be able to recover the value of its investment over the life of its assets regardless of short term fluctuations in demand.

Finally it is our view that if there is any need for risk sharing in the current arrangements it works in the opposite direction to the one suggested by the Commission. We refer specifically to the impact of the departure tax. This is a tax which, in practice, falls almost entirely on the airlines. The introduction of this tax therefore will only have a limited bearing on the *demand* for air travel at Dublin; hence Aer Lingus is constrained in its ability to increase ticket prices due to the requirement to maintain adequate load factors. Hence the charge is not in practice passed on to passengers and so neither passengers nor Dublin Airport feels any pain as a result of the new tax. Instead it is the airlines that bear virtually the entire cost, which represents a significant proportion of the average short-haul fare. In our view it is inappropriate for airlines that are suffering worst in the current economic climate to bear the full cost of this new tax. In our view the impact of this tax should be shared between the airlines and the airport by making an appropriate downward adjustment to landing charges.

Review period

The current regulation allows for a minimum of four years between regulatory reviews.

Airports are a long term business and require a sufficient degree of long term certainty over their investments. In our view this is best addressed by a long term approach to price setting which balances costs and revenues over the life of the relevant investments.

Aer Lingus supports the idea of incentive-based regulation and feels that four years is the minimum period that suffices to give the airport operator incentives to pursue efficiency improvements.

On the other hand, excessively long periods between reviews run the risk that any efficiencies that are achieved are not passed back to customers within a reasonable time frame.

On balance, therefore, we consider that a period of five years between reviews is the best balance, as is applied to the UK regulated airports. Provided a long-term approach is being taken to price setting, the primary purpose of these five-yearly reviews would be to fine tune the level of the price cap to changes in long term expectations, rather than make significant changes in response to short term fluctuations.

QUALITY OF SERVICE

On p. 14 of the consultation, the Commission raises the following questions:

- *Are parties content to rely on the indicators for quality of service described in Table 1? If not, what changes would parties propose?*
- *Should any quality of service targets that the Commission sets differ from the current levels at Dublin airport? If so, what implications are such changes likely to have for the DAA's costs?*
- *How should the Commission determine the structure and scale of any financial incentives it incorporates into the price cap to encourage the DAA to deliver service-quality targets?*

Summary of views

- Aer Lingus favours a comprehensive SLA based on a wide range of passenger and airline measures. Furthermore, wherever possible, these measures should be objectively measured, not based on subjective survey results.
- Our view is that the list contained in Table 1 consists of too many subjective measures. The list of measures contained in Table 2 (reflecting the CAA's measures) represents a preferable list of objective service measures. We have, however, identified a number of measures that we consider important that have not been captured in these lists so far.
- The DAA should base all future planning on the requirement to increase the number of contact parking stands. Airfield and taxiway maintenance needs to be improved to reduce the amount of Foreign Object Debris damage being sustained by airlines operating at Dublin Airport.
- DAA should be incentivised by penalties that are implemented as rebates off regulated aeronautical charges. These penalties need to be sufficiently large to ensure that it is cheaper for DAA to meet its SLA than to reduce service levels and pay the penalty.

Details

Which indicators

Aer Lingus has not changed its views on the issue of quality of service since it contributed to the DACC response to CP3/2008 earlier this year.

In that paper we called for the introduction of a Service Level Agreement on DAA enforced by the Commission with strong penalties where the DAA fails to provide the agreed level of service. These service levels must be defined both from both a passenger and an airline perspective.

Considering CP6/2008 we note however that the proposed metrics contained in Table 1 differ from those introduced by the UK Civil Aviation Authority and summarised in Table 4 of CP3/2008. The later list is more comprehensive in its coverage. Furthermore, Table 2 of CP6/2008, which looks at the CAA measures, highlights the fact that the CAA measures are based on objective quantification of performance, whereas the measures contained in the Table 1 are for the most part subjective and based on the results of survey data.

In addition, we consider there are a number of additional metrics that should be included in the quality of service measures. These are:

- availability of contact stands (walk-in stands included);
- availability and serviceability of fixed electrical power on all stands;
- process time at staff friskem (staff security screening points);
- airport facility delays,
- stand allocation processes (fair and equitable);
- aircraft taxi times;
- provision of PRM services.

As a general principle Aer Lingus would support the more comprehensive list of measures adopted by the CAA.

We would also favour service levels with objective measures wherever possible, rather than subjective levels measured by passenger survey. Furthermore, in order to keep up the pressure on DAA to perform, we consider that, wherever possible, service level data should be published monthly rather than annually. This would allow the Commission and airlines to place pressure on DAA to take immediate remedial action. The problem with subjective survey measures, however, is that they are subject to random fluctuation, which makes the interpretation of monthly data very difficult. This is another reason for avoiding subjective survey measures wherever possible.

Experience suggests that subjective measures from survey data are subject to significant fluctuation from one period to the next for a variety of reasons including:

- differences in the approach of the survey company;
- simple random fluctuation in responses; and
- other factors that affect respondents' subjective response to airport conditions.

By way of example, in the 1990s we understand that the UK experimented with the idea of tying performance payments to train operating companies to the results of passenger satisfaction surveys. However it emerged that serious incidents (e.g. the Paddington rail crash) lead to a *general* downturn in satisfaction ratings of all passengers including all those not directly affected by the incident or its aftermath. We would therefore argue against the use of subjective measures based on passenger surveys.

On what measures should Dublin Airport improve?

Passenger security processing times need to be reduced in peak periods. Staff security processing points should be open to meet the airlines' demands on all occasions. Fixed Electrical Power should be available and working on all stands.

Financial incentives

Aer Lingus considers that the price cap should be set in conjunction with an SLA enforced by the Commission included in the costing. Once that has been done DAA should not be rewarded for exceeding the SLA measures.

There should be financial penalties in terms of rebates from airport charges that ensure that passengers and airlines are compensated for the cost imposed by any failure on DAA's part to meet its SLA. The Commission also needs to satisfy itself that these penalties are large enough and are enforced, so that the cost to DAA of failing to meet its SLA exceeds the savings it could possibly make by doing so. Contrary to the approach adopted in the UK, we do not think it is appropriate to cap the maximum penalty for failing to meet a given service level, because to do so may leave DAA in a position of not caring about a given service level if it were to fall so low that the full penalty had been imposed.

Aer Lingus is not in a position to determine the value of these penalties as it cannot assess the costs to DAA of meeting given aspects of the SLA. We consider this is an important area that the Commission could investigate in more detail. We would comment, however, that from the point of view of maximising the incentive to meet the SLA it would be better for the Commission to err on the side of larger rather than smaller penalties. Provided the penalty to DAA is large enough the DAA should be incentivised to do its best to meet a given service level. If the penalty is set too low it will be completely ineffective as it will be cheaper for the DAA to pay the penalty than to meet its service levels.

Finally, it is our view that the DAA has a history of allowing service standards to drop in order for it then to have a pretext for additional capital expenditure to inflate its RAB. It is, in our view, essential that in the conduct of the price review the Commission does not grant DAA any expenditure to meet standards it has previously been set but failed to meet. The DAA should bear the full cost of any failure. There is a parallel in the regulation of the English water sector, where the regulator permits companies funding to meet new statutory obligations, but by default strikes out claims for expenditure to achieve existing standards that for whatever reason the company is now failing to reach.

OPEX

On p. 28 of the consultation, the Commission raises the following questions:

- *What relationship do parties think exists between passenger numbers and opex? How significant are economies of scale?*
- *What approach(es) should the Commission take to forecasting the DAA's opex needs? Which categories of the DAA's opex, if any, should the Commission review in detail? What weight should the Commission give to evidence on productivity from other airports or other sectors of the economy?*
- *What categories of opex should be included in a rolling-incentive scheme?*

Summary of views

- Aer Lingus is extremely concerned that DAA continues to operate Dublin Airport in a very inefficient manner. Our primary issue is not with the mechanisms that the Commission uses to assess efficiency. Rather we wish to see the Commission setting incentives that induce DAA to move Dublin Airport towards the frontier of efficient airports in Europe.
- However, to do this we believe that the Commission needs to review all DAA's opex in detail.
- In addition the Commission should make more use of top-down statistical analysis to support traditional bottom-up benchmarking, so as to assess the true scope for efficiency improvements. Questions regarding the elasticity of costs with respect to passenger numbers cannot really be resolved by any other approach.
- As regards what opex to include within a rolling adjustment mechanism, we believe the mechanism should cover all opex. However, it is essential that any rolling adjustment process be combined with clear service level agreements, as DAA should only be rewarded for genuine efficiencies, not for cost savings achieved by failing to meet agreed service standards.
- We further note that the Commission seems to have failed to address the issue of opex associated with T2 before the "trigger" point is reached or opex associated with non-core activities such as Dublin Airport City. The Commission should ensure that all such opex is excluded from the calculation of regulated charges.

Detail

General efficiency

Aer Lingus considers that Dublin Airport continues to be operated in a very inefficient manner and that there remains ample scope for cost reductions.

By way of example, our experience, as a formerly public-sector company, is that we inherited significantly higher labour costs than our private-sector competitors, because of the history of public sector unionisation and restrictive practices. Aer Lingus has worked hard in partnership with Trade Unions to renegotiate these arrangements and bring greater flexibility to its workforce. The result has been significant cost reductions and more streamlined management and operations. In addition, we have, in line with many other companies in Ireland and abroad, implemented a pay pause as a result of the current downturn By contrast, we see no such parallel effort coming from DAA, which still operates with the same high cost practices that we have worked so hard to correct. The DAA states that it must charge to the cap as a result of pressure on pay costs which result from national pay deals and increments. This is the action of a monopoly out of touch with what is going on in the real world.

Another example of DAA's failure to embrace change and efficiency relates to T2. It was our initial understanding that an independent terminal operator would be appointed for T2, to promote efficient operation and a degree of inter-terminal competition at the airport. Instead, DAA has been instructed to draw up a specification for a "facilities manager" and so instead of addressing the issue at hand, DAA has instead introduced another layer of bureaucracy.

We note that the Commission does not, at this stage, take a view as to whether Dublin Airport's efficiency has improved or declined in recent years. Instead it considers the conclusions it could draw based on different values for the elasticity of costs with respect to passenger numbers. Our first comment on this is that the CAA in its recent airport review in the UK has adopted a cost elasticity of 0.3. Applying this figure to DAA (rather than 0.45) would suggest a materially greater degree of inefficiency remaining at Dublin Airport.

But in our view the key point is that from the perspective of airport users it is clear that the airport has become less efficient, not more so, over the last few years. The solution to this lies in the Commission setting challenging targets for the DAA that force it to get its house in order, combined with a clear SLA to maintain service quality, with penalties that bite if the airport fails to deliver.

In order to set these targets, the Commission needs to conduct a comprehensive review of the DAA's costs. This review needs to look at costs on a bottom up basis. But experience from previous reviews at Dublin suggests that the bottom up approach the Commission has adopted has not led to the setting of sufficiently challenging targets to make DAA operate more efficiently.

The problem with bottom up benchmarking studies is that it is very difficult to conduct a study that covers all of the airport's activities. This is either because some activities are difficult to measure or because of difficulties of comparison between airports because of the different services on offer or the different ways in which airports are organised.

In addition, bottom up approaches tend to:

- be partial measures and hence ignore differences in factor prices and factor substitution in production (i.e. a good performance on one partial measure may reflect under performance in another);

- struggle to take into account differences in operating environments; and
- have difficulty handling multiple outputs.

Bottom up studies can often be useful indicators of efficiency in specific areas but are less effective in assessing overall efficiency. Therefore the implication of such analysis, in terms of the efficiency targets, is open to subjective reasoning.

The Commission therefore needs to supplement its bottom up analysis with some robust top-down statistical analysis. This analysis needs to address data from a range of airports over time, so that it can capture differences in operating environment and the elasticity factors the Commission is concerned with.

Techniques such as linear regression, Data Envelopment Analysis (DEA) and Stochastic Frontier Analysis (SFA) carry a higher degree of mathematical rigour but are demanding in terms of data. Despite this, in the case of the airport sector, there is a growing body of mathematical and econometric analysis (e.g. Efficiency in Italian Airports Management: the implications for regulation, Malighetti et al, 2007; The Technical Efficiency of UK Airports, Carlos Pestana Barros, working paper; ATRS Global Airport Performance Benchmarking Project, 2008). This kind of analysis may cast light on:

- the effects of economies of scale or scope and "technical efficiency", which is a prime concern of the Commission;
- the difference between changes in labour productivity and changes in the unit cost of labour (which is a key issue as far as we are concerned);
- exogenous operating factors (not under the control of airport managers) and "net technical efficiency".

Aer Lingus would strongly recommend that the Commission explores more rigorous statistical measures of Dublin Airport's efficiency to supplement the more subjective bottom up approaches.

Rolling adjustments

The Commission asks what categories of opex should be included in the rolling adjustment scheme. It seems clear that the DAA will argue that a significant proportion of costs are not controllable and that these costs should not be in the scheme.

We urge the Commission not to confuse the passenger elasticities mentioned above, which say something about the cost / volume relationship, and fixed costs. We consider that in a well run business there are no fixed costs in the sense of costs that cannot be subject to efficiency improvement. Whether these costs vary with volume is irrelevant.

Our view therefore is that all of DAA's opex, measured in real terms, needs to be included in the rolling adjustment. By "real terms" we mean that the outturn costs should be adjusted for the Commission's estimate of the relevant inflation rate for the cost concerned. If the DAA's labour costs rise it should not be penalised for market increases in the cost of labour. But it should be penalised if it is using too much labour or letting its unit labour costs run ahead of market rates.

Furthermore, any rolling opex adjustment scheme should only be implemented in conjunction with a clear and binding service level agreement. As has been demonstrated by the discussion of BAA in the recent UK regulatory review, price cap regulation creates incentives for the regulated entity to cut costs by failing to meet service standards.

Aer Lingus could not accept DAA being rewarded through a rolling adjustment mechanism for cost savings that are not genuine efficiencies but are rather the result of cost savings achieved at the expense of DAA's customers.

Other cost issues

On the topic of opex, Aer Lingus would like to raise two issues for consideration that are not covered in the Commission's consultation.

The first relates to the debate on triggers for T2. This matter is dealt with in more detail in the capex section below. However, we note that the debate so far has only concerned the timing of when capex related to T2 is included in the RAB. But in our view DAA will be incurring opex costs related to T2 before the terminal comes into operation.

Economic efficiency suggests that these costs should not be allowed in DAA's base opex as they relate to costs for a service not yet being provided. Similarly, even once the box 1 trigger has been passed, T2 will have higher than necessary opex because of its excessive size. Therefore the Commission should only allow opex costs commensurate with a terminal of the size implied by the box 1 conditions until such time as the box 2 trigger is reached.

Secondly, Aer Lingus is concerned that DAA's opex may be inflated because management time is being spent on developing non-core activities such as Dublin Airport City. In our view it is essential that DAA bears all of these costs itself. The Commission therefore needs to examine DAA's costs closely and satisfy itself that there is a comprehensive activity-based costing approach to separating the full overhead costs of non-core activities.

COMMERCIAL REVENUES

On p. 37 of the consultation, the Commission raises the following questions:

- *What relationship do parties think exists between passenger numbers and commercial revenues?*
- *How might the Commission forecast targets for commercial revenues that the DAA might collect during the next determination? What weight, if any, should be attached to evidence from the macro economy or from other airports?*
- *Are there any categories of commercial revenues for which the Commission should not provide the DAA with incentives to maximise the yield? If so, how should the Commission treat such revenues?*

Summary of views

- The relationship between passenger numbers and commercial revenues is complex as it depends on a range of factors within and outside the airport's control. Per-passenger revenues will be affected by macro-economic factors and the mix of long haul and short haul traffic as well as the effectiveness with which the DAA organises its commercial activities. Top down statistical analysis is necessary to quantify these trends.
- Aer Lingus considers the Commission should take a balanced approach to assessing the potential for generating commercial revenue. However, our view is that the Commission should make more use of top-down benchmarking approaches than it has to date.
- Our view is that all revenues recovered from airlines for services necessary for the provision of air services should be included within the regulated price cap. This would prevent a repetition of the move by DAA after the last price review to raise charges for access to infrastructure and SSKs, which involved significant double counting of revenues.

Details

Assessing the level of commercial revenues

Aer Lingus' view is that the Commission has to date made a respectable attempt to forecast DAA's commercial revenues at Dublin Airport. However we do consider that there is scope for improvement.

We would support the use of a balanced approach to setting commercial revenue targets for DAA, based on a range of bottom-up and top-down evidence.

In particular, we would stress the benefits of proper top-down benchmarking between DAA and other airports. The Commission is rightly interested in the elasticity between passenger numbers and commercial revenues, and which other macro-economic factors can be used more accurately to forecasts commercial revenues. These factors cannot be identified and quantified using bottom-up techniques. It is necessary to take a statistical approach that is capable of abstracting from the differences between airports and identifying the similarities in trends between per passenger commercial revenues and macro-economic trends such as GDP, disposable incomes and retail sales. A statistical approach should also be able to disaggregate the differences in commercial revenues that result from differences in traffic mix between long haul and short haul services, and in-mix between full service carriers and low cost operators.

Treatment of check-in desks, etc.

In 2007 the DAA applied to increase charges for access to installations and for rental of space for SSKs. These charges are not governed by the price cap determined by the Commission, but are subject to separate approval by CAR under the Ground Handling Regulations. The DAA argued that the costs of operating these facilities were not covered by their existing charges.

At the time Aer Lingus expressed the strongly held view that any shortfall in revenues relative to costs was already subsumed within the regulated cost base, because of the way the single till works. As a consequence DAA was wrong to state that it was not recovering the full cost of these facilities, even if it were the case (which is not accepted) that the direct charges for these facilities were less than the incremental cost of providing them. Any shortfall simply implied higher regulated aeronautical charges.

The debate at the time raised the general issue that there are a range of charges levied by DAA which do not fall within the regulated price cap, but are for services that are essential for an airline in the provision of air services to passengers. These charges include check-in desk fees as well as access to installation fees, miscellaneous charges (e.g. airside permit fees) and space rental for SSKs . DAA has market power with respect to the determination of these charges, because airlines cannot bypass these services.

Our view, in support of the opinion expressed by the DACC earlier, is that Airport Charges should be redefined to encompass all charges over which DAA has market power. We note that the Commission has stated that it does not have the authority to make such a change. Nevertheless, we call on the Commission to request the Minister of Transport to make the necessary legislative changes that are required to achieve this end at the earliest possible opportunity.

PASSENGER FORECASTS

On p. 17 of the consultation, the Commission raises the following questions:

- *What do parties think are key drivers of passenger growth trends at Dublin airport?*
- *Are parties able to provide robust empirical evidence on the strength of the relationship between passenger numbers and any specific drivers? If not, can they suggest information that the Commission might collect in order to quantify possible relationships?*
- *What forecasts might the Commission use to project values for other drivers thought to influence passenger trends? For example, if the Commission concluded that GDP growth or oil prices have been important drivers of passenger volumes at Dublin airport, what values should it assume for these series beyond 2009?*

Summary of views

- Aer Lingus considers that DAA has to be responsible for demand forecasting, but that this demand forecast needs to be prepared in conjunction with the CIP.
- The Commission should seek independent verification of this forecast, including the assumptions that have gone into constructing it.
- We believe that the forecast should take into account the long term relationship between GDP and passenger growth. However, it should also reflect the likely impact of long term rising costs and the short term way in which airlines cut prices to achieve target load factors, which insulates the airport in the short run from the impact of economic downturn on passenger numbers.

Details

General process

Aer Lingus does not produce market demand forecasts for air travel and so it does not have detailed knowledge of how passenger demand should be forecast. While Aer Lingus and other airlines can comment on their own fleet development plans, each individual airline is not necessarily best placed to comment on the bigger picture.

Nevertheless, it is clearly in all users' interests that forecasts for Dublin Airport are as accurate as possible so that the airport provides appropriate levels of capacity (neither too much nor too little) and so that sensible commercial revenue forecasts can be included in the single till.

Furthermore it is our view, somewhat reluctantly, that the source of the demand forecasts for Dublin Airport has to be the DAA, because it is the body that ultimately has to deliver the investment plan against these forecasts. However, we remain understandably concerned that DAA has a built-in incentive to over-forecast demand in the long term, to justify substantial investment plans, while it has an incentive to under-forecast passenger numbers in the short run, so as to understate its projections of commercial revenues in the single till.

It is therefore essential that the DAA's forecasts be subject to scrutiny by airport users, but more importantly that they be vetted by an independent body who can cross check these forecasts against other independent projections (such as those from IATA), and has the authority of the Commission to alter these forecasts in light of its own experience and the comments received from the airport users. This process needs to occur early enough to ensure that DAA is able to reflect these approved forecasts in its CIP and other financial projections.

Key drivers of growth

It is our view from interactions between the DACC and DAA that DAA's passenger forecasting methodology is simplistic and based in effect solely on the long run relationship between growth in GDP and growth in passenger numbers.

Although not being experts in this area we are aware that there is a long term relationship of this nature that tracks passenger numbers reasonably closely.

However we are concerned that by modelling passenger numbers according to this approach DAA will be wrong in both the short run and the long run in the way we outlined above.

In the long run it is clear that airline costs are likely to rise significantly in real terms (in particular through the increasing cost of aviation fuel, EU ETS and departure taxes). These costs will be passed through to some degree (but in our view not in full – it is estimated that 75% of the additional costs will need to be subsumed by airlines) in ticket prices, which will cause passenger demand growth to slow down relative to the growth of GDP. If this long run trend is not captured there is a serious risk that DAA will seek funding for excessive levels of capacity at Dublin, which will end up being paid for by existing users.

In the short run, if the DAA bases its forecasts solely on GDP in our view it will *under* predict passenger numbers relative to the likely outcome. This is because of the way, as described above, airline pricing works to maintain load factors and so insulates the airport to a material extent from the effect of the downturn on passenger numbers. This process is not symmetric with surges in demand, because it is much easier for an airline to increase capacity in the short run than it is to reduce capacity in the face of a downturn.

Data sources

We do not have any specific expertise regarding which series to use. As we have stated, we consider that DAA's forecasting methodology should be independently vetted. In addition, it seems sensible that such a vetting process takes a view about the factors used as inputs to the forecast. On the face of it we would consider it appropriate for DAA to use forecasts of drivers produced by reputable independent bodies, rather than make its own forecast of the macroeconomic drivers.

CAPITAL COSTS

On p. 48 of the consultation, the Commission raises the following questions:

- *What should be included in the RAB? How might the trigger that T2 "be operationally ready" before the first tranche of costs for this project are included in the RAB be defined in practice?*
- *What approach to depreciation should the Commission take?*
- *How should the Commission determine a cost of capital for the DAA?*

Summary of views

- Only investment that has reasonably and efficiently been incurred for the benefit of airport users should be included in the RAB. Aer Lingus' view is that there are reasons to ask whether the level of investment in T2 is efficient. Our view is that the Commission should impose a reduction on the RAB to reflect this inefficiency.
- In addition some aspects of the cost of T2 have been incurred due to design flaws in DAA's original plan or without the approval of airline users (such as the linking walkway to Pier B). These elements should be excluded from the RAB
- As regards triggers for T2 our view is that no element of T2 should be added to the RAB until Dublin Airport has the capacity to take advantage of T2, which will not occur until the second runway is operational.
- Furthermore, no prefunding of either box 1 or box 2 of T2 should be allowed in the RAB.
- As regards depreciation, as stated previously, our view is that all capital costs for long-lived assets should be recovered on a per-passenger basis, not merely the depreciation on T2.
- We agree with the Commission's broad approach to the cost of capital, but stress the need for the Commission to take a medium term view of the cost of capital that is not unduly influenced by present volatile market conditions.

Detail

Inefficient capital costs

Aer Lingus recognises the need for T2 at Dublin Airport in the medium term, but considers that T2 is over-specified and over-costly given the needs it is designed to meet. It is also our view that in the development of T2 DAA has demonstrated a disregard for changing economic conditions that would not be possible for a company not similarly protected by regulation.

This latter point is demonstrated by the fact that DAA has not altered its plans for T2 in any way as a consequence of the economic downturn. It has not investigated the possibility of down-scaling the T2 plan, or phasing it to better correspond to a slower growth in passenger numbers that now seems likely.

Furthermore, in two other respects the development of T2 seems to be inefficient in a way that should not be rewarded within the RAB. First, the plans for T2 have remained unchanged despite the fact that since T2 was originally designed DAA has identified and developed various additional lower cost to expand capacity in T1, in particular Pier D, Area 14 and T1X.. It also demonstrates that DAA's expansion plan was not efficiently constructed to begin with, because in planning T2 is did not take into account these incremental and cheaper expansion options.

Secondly, it is our impression that T2 has been over-specified to create a "wow" factor that makes a statement about DAA as an airport operator. Aer Lingus is not averse to DAA investing its own shareholders' money in making a corporate statement. But we do not think it is appropriate, or consistent with the Commission's duty to ensure the efficient development of the airport, that airport customers should pay for such a statement.

In our view the cost of T2 allowed in the RAB should be reduced to reflect these inefficiencies.

Design flaws and other non-agreed capex

In addition to the general over-specification of T2, we believe there are specific costs incurred by DAA that result from design flaws in the original plan or facilities that are being built by DAA without the agreement or approval of its customers.

In the first category is the linking walkway between Pier B and T2 that was not in DAA's original plans but has had to be constructed to allow arriving passengers to transfer from that pier to the Terminal. This cost (€12m) should be excluded from the RAB as it results from bad planning on DAA's part.

In the second category is the CBP Pre-Clearance facility that is being built for T2 at a cost of €32m. As well as being badly configured, (it provides for no built in baggage storage, no baggage reconciliation system, no automated transfer facility between the baggage hall and CBP Pre-Clearance facility secondary examination area, and it contains insufficient ULD storage systems) this facility is being built without airlines being asked whether they wanted it, without the agreement of such airlines and at no benefit to them. It is designed and operated in such a way as to drive additional opex to airline operators that use it. For airlines that do not use it, no cost associated with it should be incurred. As a consequence, it is our view that the cost of this facility should be excluded from the RAB.

Triggers

Aer Lingus has made its views known already that we do not consider it appropriate for any part of the cost of T2 to enter the RAB until such time as T2 provides real additional capacity to Dublin Airport.

T2 was originally envisaged in conjunction with a second runway, which has since been delayed and is likely not to be built before 2013 at the earliest; indeed it has just been announced by the DAA that it now intends to defer the second runway for an unspecified period. As it is runway capacity, not terminal capacity that constrains Dublin Airport at present, the opening of T2 will not facilitate any increase passenger movements.

The effect of the Commission's Box 1 is to add significant costs to the RAB at a time when passenger numbers cannot increase. As a consequence airport charges will increase significantly. This is not acceptable and is in our view contrary to the Commission's duty to promote efficiency at the airport. In competitive markets firms can only charge for what they can sell. In this case DAA cannot sell additional capacity created by T2 because of the runway constraint.

As a consequence we believe the trigger for the inclusion of T2 costs in the RAB should be the point at which the second runway becomes fully operational, not the point at which T2 begins fully functioning.

However, we also wish to make it clear that we disagree with the Commission's policy of allowing DAA pre-funding of the financing costs of T2. This too is contrary to good economic principles. As we have stated previously it is our view that financing costs should be capitalised at the risk free rate up to the point where the second runway comes into operation.

Depreciation

We have already discussed the topic of depreciation in our response to the general methodology, so we will not repeat our views at length here.

Our view is that the Commission should adopt a long term pricing model that recovers the cost of investment over its expected life on an even per-passenger basis.

This requires all capital costs, depreciation and return on the RAB, for long-lived assets to be amortised over the asset's expected useful life. Periodic reviews then become a process of resetting priced to reflect changes in long term expectations, not adjustments to reflect short-term economic ups and downs.

At present the Commission is caught in an inconsistent halfway house, where only depreciation on T2 is treated on a whole life per passenger basis, while other capex is allowed in prices through a conventional "accounting" approach.

Cost of capital issues

Our view is that the broad methodology proposed for the cost of capital is appropriate. We believe that the main components of the cost of capital should set based on medium to long-term trends. This is appropriate given the nature of the regulatory regime and the long asset lives. It is not necessary or appropriate to change the approach to the cost of capital in response to the current financial market conditions.

The issues paper does not refer to the potential impact of the 'credit crunch' on the cost of capital. It is clear that the credit crunch has resulted in an increase in some components of the cost of capital and, in particular, the debt premium has increased significantly in recent months. However, the impact of the 'credit crunch' on the allowed return to DAA should take account of the following:

- Current financial markets are volatile – the current situation could change quickly;
- There is evidence that investors are still prepared to invest in regulated infrastructure assets;
- Regulatory best practice is to take a medium to long-term views on the main components of the WACC (ERP and risk-free rate) – it is appropriate that this approach is retained; and
- The extent to which DAA already has medium-term finance in place on pre-'credit-crunch' terms.

Recent cost of capital decisions in the UK have resulted in lower pre-tax cost of capital values than the 7.45 allowed for DAA in 2005:

- Heathrow – 6.2%
- Gatwick – 6.5%
- Stansted – 7.1%

The UK decisions include the higher corporate tax rate (28% vs. 12%). Adjusted for the gap in the cost of capital values is greater. It should be noted that the Stansted determination was made in December 2008 and took account of the latest evidence on the impact of the credit crunch.

The key differences are:

- A higher equity risk premium for DAA;
- A Beta value that is higher than that used for Heathrow or Gatwick.

The value of 6% for the ERP used in 2005 is at the top of the range used by regulators in developed economies. It appears to be based on historic data on equity returns. While this is an important source of evidence on the forward looking ERP, our view is that the assessment of the ERP should also take account of:

- Academic evidence on the ERP;
- Surveys of investors and financial experts; and
- Evidence from the financial markets (e.g. dividend growth model estimates).

Other regulators have considered these forms of evidence and have tended to choose a central value for the ERP in the range 4% to 5%.

The evidence used by the UK Competition Commission ("CC") and CAA to determine the appropriate Beta value included:

- Beta estimates for BAA prior to acquisition by Ferrovial;
- Disaggregation of BAA beta based on assessment of risks at different airports;

- Beta estimates for other quoted European airports; and
- Beta estimates for other industries (utilities, real estate and airlines).

These forms of evidence will be relevant for determining the appropriate Beta value for DAA, though the relevance of the BAA data will tend to decline over time. Nevertheless, the detailed analysis undertaken by the CC and CAA provides a valuable foundation for the assessment of DAA's Beta.

FINANCIAL VIABILITY

On p. 50 the Commission has asked whether we consider its approach to assessing DAA's financial viability is appropriate, our views relating to the possible impact of the break up of DAA on its debt position and the relevance of non airport assets.

Our view is that the Commission's general approach is in line with normal practice of economic regulators. However, it is also our view that if the Commission adopts the long-run approach to pricing outlined above then this provides significant long term insurance to the airport as regards its ability to recover an adequate return on the investment contained in the RAB.

As a consequence we consider that the Commission should be very wary of making any adjustments to aeronautical charges to reflect short term financing issues when long-term financing is effectively assured. Furthermore, insofar as the Commission were ever to make such an adjustment it is essential that the effect is neutral in net present value terms: that is any acceleration of revenue for financing reasons must be returned in full to customers, including interest.

The Commission is also right to highlight the importance of debt in the break up of the three state airports. Currently a significant proportion of DAA's debt relates to investment in Cork Airport. It is essential that the Commission does not allow DAA to transfer debt to Dublin Airport in the disaggregated model. The Commission must take a view on the appropriate maximum level of gearing that can be consistent with Dublin Airport maintaining a minimum investment grade.

OTHER ISSUES

General aviation

The current pricing at Dublin allows too much airport capacity to be taken up by general aviation. A new charging regime is needed that would make general aviation take into account the knock-on effects that it has on the airport's capacity to take more commercial aviation.

In our view this is best achieved by structuring airport charges as a two part tariff, with a fixed minimum charge per aircraft movement and a discounted charge per passenger.

Dublin Airport City

Aer Lingus' only concern with DAA's development of Dublin Airport City is to ensure that *all* the costs of its development should be ring-fenced from the costs of the regulated airport business and do not in any way affect airport charges. This includes the costs of DAA's management time spent on developing the project.

Price cap compliance

Aer Lingus thinks that the current price cap compliance arrangements are working well. We do not think there is any compelling need to alter the arrangements. In particular a system of making adjustments to charges within years, rather than annually would be excessively cumbersome and expensive for little or no practical benefit.

STRUCTURE OF CHARGES

In addition to the issues raised in the consultation, Aer Lingus is concerned by the further matter of how DAA *structures* charges at Dublin Airport, quite aside from whether the Commission controls the overall level of charges in the appropriate way.

This is a general issue of economic efficiency and hence we believe it is the Commission's duty to ensure that the DAA gets these pricing structure issues correct within the overall determination.

T2

The first matter relates to the possibility of differential charging for T2 compared to T1. While it appears that the DAA have not at this point stated any intention to levy differential charges, it is clear from the various statements it has made that the Commission considers that differential charging to recover the costs to T2 may have merit. In this respect we consider that the Commission is completely wrong.

From a commercial point of view it is impossible for Aer Lingus or any other airline planning to use T2 to accept differential charging. Location in T2 will provide no particular competitive advantage to the airline. Hence if the DAA were to levy higher charges on T2 users those airlines would suffer a serious competitive disadvantage compared to their rivals in T1. In a sector operating on such slender markets no airline would choose to operate on that basis.

For this reason alone we do not think that DAA will voluntarily introduce differential charging for T2. But we remain concerned that the Commission may force the DAA to do so in any event.

As well as being commercially unacceptable, we would also like to reiterate our view that any form of differential or peak pricing for the use of T2 is not justified from the point of view of economic efficiency. In the first place, T2 provides additional capacity for the benefit of airport users as a whole and so the extra space created by T2, insofar as it is a benefit, benefits all airport users, not just those in T2. Secondly, T2 is specified to the same standard of service as T1 (IATA level C), so there is no justification for charging differential rates on the basis of service quality offered. Finally, as we have pointed out here and elsewhere, the constraint on capacity at Dublin comes from lack of runway capacity, not lack of terminal capacity. Consequently there is no justification in placing the burden of capacity constraints only on the users of T2.

Check-in desks in T2

The second issue Aer Lingus has with the proposed structure of charges at T2 relates to the rental charges for check-in desks.

T2 is designed to have 56 check in desks. Aer Lingus anticipates using all of these desks during peak periods and c. 28 desks off peak. Contrary to Aer Lingus' wishes, DAA has designed all 56 of these check-in desks for manned operation, whereas Aer Lingus believes that it will make extensive use of SSKs and self-tagging kiosks. These are much cheaper to construct and maintain for DAA. But because DAA have specified all 56 desks to be capable of being fully-manned we believe DAA will expect Aer Lingus to pay the full cost of these desks in the rental charge.

In our view this is unjustified and contrary to the principles of economic efficiency. First, given that Aer Lingus plans to make permanent use of 28 desks and requires only a small percentage of those to be manned desks indicates that DAA has been inefficient in the design of T2 by over specifying check in desks that its principle customer does not need or want.

Secondly, while we accept that DAA might want to specify the maximum operational flexibility for the desks that Aer Lingus will use only during peaks, it is wrong to expect Aer Lingus to pay for this flexibility. The extra flexibility planned by DAA is a commercial decision and one on which it should take the commercial risk.

Consequently we consider that market-driven prices (as opposed to prices imposed by DAA using its market power) would set charges for SSKs and self tagging kiosks at their appropriate stand alone cost, while the incremental cost to DAA of providing desks capable of being manned should be recovered from charges for the use of those desks in a manned configuration. In that way all users pay for the service they receive and the costs that they impose on the airport.

We consider that the Commission should require the DAA to structure check-in desk rentals in a two-tier fashion that properly reflects the needs of airlines and the costs they impose on the airport.