

Comments by Aer Lingus on Submissions to the Commission for Aviation Regulation

16 April 2001

Aer Lingus welcomes the opportunity to comment on other parties' submissions to the Commission on its paper, *The Economic Regulation of Airport Charges in Ireland*. In this response, we comment only on the submission by Aer Rianta, since our interest in this process is solely as customers of Aer Rianta. We provide our response to a number of arguments advanced by Aer Rianta below, employing the numbering scheme used in its own submission. Our comments cover only those areas of most immediate concern or factual inaccuracy. This document should not be taken as an exhaustive statement of our views and it should not be assumed that Aer Lingus supports any of Aer Rianta's positions on which we do not comment.

The statements we made in our own submission to the Commission stand. In particular, we believe that Aer Rianta's arguments provide evidence in favour of one of the key themes of our submission: the need for effective consultation in the areas of service quality, investment planning and charging structures. A number of statements in Aer Rianta's submission appear to indicate that it believes that existing consultation is adequate and that regulatory involvement is unnecessary. At the same time, Aer Rianta proposes a number of significant changes that have never been discussed with Aer Lingus. We remain convinced that effective consultation will not emerge without the regulator's backing and that this process should begin during the present price review, while it is still possible to propose a credible regulatory alternative if effective consultation mechanisms cannot be implemented.

3 The context for regulation

3.4 Economic regulation

3.4.2 Market failure

Aer Rianta argues that airline carriers are the key possessors of market power at airports, counteracting any possible market power that rests with the airports. We do not accept this view. Airlines are customers of a monopoly service provider. If service quality falls, we and our customers have no redress. If charges increase, we will pay them. Either our profits will fall, or we will increase fares to pass the charges through. In either case, the airport operator faces no detrimental consequences from his decision.

In standard economic theory, a monopolist has the power to influence price by withdrawing supply from the market (in contrast to a competitive firm, which would lose business by doing so). Aer Rianta can raise charges without significantly losing business. Monopoly power can exist on the buying side, in principle, if a customer can reduce price by threatening to take business elsewhere. The alternative options to Dublin Airport for any airline seeking to serve the market to Ireland are

very limited. No alternatives exist for Aer Lingus. We have no market power vis a vis the airport operator. If the airport operator were unregulated, it would exploit us and, through us, our customers: the passengers.

We find the conclusion of this section of Aer Rianta's submission bizarre. It states, "fulfilling the interests of airline customers must be balanced with the requirement for long-term development of airport facilities." We do not understand the implied conflict of interests. It is in our interests, and those of our passengers, for charges to be low. Equally, it is in our interests, and those of our passengers, for necessary development to be efficiently undertaken. Obviously, there is a balance to be struck between the objectives of low charges and high service quality. However, it makes no sense to characterise this as a conflict between airlines' interests and wider interests of passengers in the long run.

We believe that our interests in this review are the same as those of our passengers. If airport charges rise, we have to present the increased price to our customers as a fare increase. If flights are delayed or check-in and baggage delivery are congested, passengers typically blame the airline. Together with our passengers, we pay Aer Rianta's costs and suffer from any poor service it provides.

A key theme of our submission was therefore the need for the regulator's support in forcing Aer Rianta to take account of airport users' views. We proposed a dynamic consultative forum for users to approve investment decisions, effective consultation for changes in charging structures and service level agreements to improve quality. These direct mechanisms for giving customers a voice would be more effective and more flexible than detailed regulatory involvement at the airports. The balance of market power is so heavily weighted towards the airport operator, however, that they will not be set up without the regulator's active support during this price review.

3.4.3 Competition at Aer Rianta airports

Aer Rianta claims that Galway and Kerry airports compete with Shannon and Cork, respectively. Since the second sentence of Section 2 ("Overview of Aer Rianta") states that the company's airports handle 97% of airport traffic in Ireland, we would suggest that any such competition is clearly ineffective. In any event, differences in geographical location, infrastructure and airport capacity between the various airports mean that competition between them is minimal. Moreover with regard to competition between Galway and Shannon, Galway is significantly impeded because it lacks Shannon's position as established by the North American bilateral agreements.

Within airports, it is claimed "competition takes place in Aer Rianta in relation to certain aeronautical and non-aeronautical activities/services". We are not aware of any competition to Aer Rianta in the provision of aeronautical services and would appreciate clarification on this point.

Even for non-aeronautical services, we do not accept that competition at Irish airports exists to the degree implied by Aer Rianta. Of the services it describes in its submission, car parking is clearly a monopoly, as is airline catering at Cork and Shannon. There is only limited competition in airline catering at Dublin, as there is in banking facilities and retail activities. In some cases - such as duty-free and duty paid - Aer Rianta itself acts as a monopolist. In others, it authorises a sole

provider, and thereby is able to extract monopoly rents through the charges on such a retailer. We would like to see more competition in the provision of services to airlines. We have no direct interest in the competitiveness of the commercial activities but Aer Rianta's ability to receive monopoly profits from these activities strengthens the case for the single till, as we discuss later.

4. The regional contribution of airports

Aer Rianta provides considerable evidence of the importance of airports to regional development but appears to downplay the obvious point that airports only contribute to regional development if passengers use them. Traffic will increase in response to lower charges (a point Aer Rianta make several times elsewhere in the document). Consequently, regional development will be promoted by airport charges that reflect only efficient operating costs. Aer Rianta appears to be implying that more investment in Cork and Shannon would promote regional development. In our view, several aspects of these airports' operations are already gold-plated and regional development would most effectively be promoted by ensuring that airport users do not have to pay for this inefficiency.

5 Framework for regulation

5.2 Forms of price cap

Aer Rianta argues against a simple revenue cap, on the grounds that revenue would not increase as traffic and costs increase. We support this view. However, Aer Rianta proceeds to argue for the other extreme: the "revenue yield" approach in which revenue would increase one-for-one with traffic. We believe that this would over-compensate the airport operator for traffic growth, leading to unnecessarily high charges.

While cost does indeed rise as traffic increases, we do not accept that it increases proportionately. There are clearly economies of scale in the provision of airport services. As Aer Rianta note in Sections 5.4.1 and 10.1 of their submission: "the impact of economies of scale can be significant". As volumes grow, unit costs can be expected to fall. Consequently, revenue should not rise in proportion to traffic. If we understand the Commission's categories for price caps correctly, this points to a hybrid tariff/revenue cap as suggested in our submission if charges are to be cost-reflective. We do not accept Aer Rianta's assertion that this would be complex and administratively unworkable .

Flexibility in pricing structures

We have some general comments on Aer Rianta's proposals for loose regulation of its prices for different services. These comments also relate to its more specific proposals for a new charging structure, set out in its section 12. We believe that there should be effective and detailed consultation on these issues and that the regulator should act to ensure that this is implemented.

Aer Rianta consistently makes a case for being allowed the maximum possible flexibility in setting charges within the price cap. For example, it argues for a single cap for the three airports (which we support while the existing North American bilateral agreements remain) and a single cap on all

charge categories (which we oppose).

We understand Aer Rianta's views on this issue and we do not want to see inflexible regulation or "micro-management" by the regulator. However, we are concerned about possible discrimination in tariffs that Aer Rianta might seek to introduce. In some cases, Aer Rianta's own commercial imperatives could lead it to introduce discriminatory charges (Ramsey pricing, for example, can be highly profitable but is not cost-reflective). Aer Rianta's past behaviour suggests that it might attempt to introduce discriminatory differentials for non-commercial reasons. Aer Lingus has suffered commercially from such discriminatory pricing schemes in the past and we are concerned that this should not happen again.

Our ideal solution, as for many of the issues raised in the consultation paper, is for airport users to be given a more effective voice in approving or rejecting Aer Rianta's proposals. We proposed that airport users should be consulted over changes in tariff structures. This remains our preferred solution and if it can be established, the regulator will be able to adopt a more "hands off" approach of not acting unless there is disagreement between Aer Rianta and its customers. However, if this more effective consultation mechanism cannot be established before the price control is introduced, then it is essential that the regulator takes the power to approve or reject any proposed tariff rebalancing. We support the principle of regulation with a light touch, as does Aer Rianta, but we believe that it is only possible when customers have an effective voice. Since Aer Rianta is a monopolist, such a solution will only emerge with the regulator's active support.

5.4 Regulation as a Group

As we noted in our submission, we support a single price cap for the three airports only while the existing North American bilateral agreements remain. While airlines do not have a completely free choice as to whether to use Shannon, it would not be appropriate for all of its costs to be recovered from its captive users. However, if restrictions were lifted so that airlines and passengers could make a free choice, then airport charges should reflect each airport's own costs, requiring separate price caps.

6 The Regulatory Till

Aer Rianta supports the "dual till" approach, under which aeronautical charges would increase to cover all aeronautical costs, while revenue from commercial activities is unregulated. In our submission, we supported the continuation of the single till approach, under which the profits from commercial activities contribute to the costs of providing aeronautical facilities and services.

It is unsurprising that Aer Rianta supports the former option since, as they admit, an airport operator would obtain windfall profits from such a change. Airport charges would increase, while commercial revenues would not fall. Overall, passengers would pay more and Aer Rianta's profits would be higher.

We believe that there would need to be an overwhelming case in favour of the dual till for the regulator to decide to raise charges to increase a monopolist's profits in this manner and the burden

of proof should rest with Aer Rianta. The arguments advanced by Aer Rianta fall well short of the standard of proof required. For example:

- Aer Rianta claims that investment will suffer under a single till, as the airport operator is denied funds for capital investment. Our understanding of the proposed regulatory framework is that Aer Rianta's charges will be set to allow it to finance efficient investments, under whatever approach is taken on the dual till/single till question. Moving to a dual till would simply allow Aer Rianta to make additional profits, above the allowed rate of return, while still carrying this investment out. Aer Rianta needs to be more specific: what investments will it fail to make under a dual till approach, and why?
- Aer Rianta argues that airport charges under the single till are artificially, inefficiently low. We do not accept this characterisation. The argument appears to be that aeronautical services are for the benefit of airlines and passengers alone, not for the owners of commercial activities. Certainly, aeronautical services are essential to airline operations at an airport. However, they are also essential to maintaining commercial profitability at the airport. Commercial activities are located there because airlines serve the airport and their passengers fly to, from and through it - not because it is a pleasant place to be. The aeronautical services represent an essential cost of jointly providing air transport and profitable commercial services. Both activities should contribute to this cost.
- We do not accept that the single till encourages congestion. Airlines' and their passengers' interests are best served by swift passage through the airport. Commercial interests are often better served by delays. If Aer Rianta is free under a dual till to make increased profits from expanding its commercial activities, it may inefficiently allocate excess space and other resources to commercial activities. Increasingly, it may see its role as providing opportunities for its captive market to shop, rather than investing and operating the airport efficiently to ensure that this captive market is swiftly sent on their way. We do not regard this as an improvement over current practice.

We do not claim that the case for the dual till is entirely without merit. Rather, there are complex economic issues that can be raised supporting either side of the argument. We do, however, claim that the burden of proof should rest squarely with those seeking to increase Aer Rianta's profits at customers' expense by introducing a dual till. There needs to be specific benefits cited (to airport users, not just Aer Rianta) to counter-balance the clear costs of higher charges to airport users. That case has not been made.

7 The Regulated Asset Base

7.3 Rolling forward the RAB

Aer Rianta argues for taking variations in replacement cost into account when rolling forward the regulatory asset base (RAB). This approach has been rejected for most of the UK's regulated industries because:

- Replacement costs may be unstable, resulting in changes in charges to customers for no change in

service;

- Some utilities may have market power vis a vis their suppliers, giving them some control over replacement costs.

Aer Rianta refers to the substantial difference in estimated RABs between British Gas and Ofgas in the MMC's review of BG Transco's last price determination. Both of the problems listed above were discussed. Effectively, BG as a large buyer of pipeline and other gas equipment in the UK had substantial influence on "the replacement cost" of gas equipment. A utility in this position, by purchasing inefficiently, could revalue its entire regulatory asset base and substantially increase its returns on shareholders' actual investments if the RAB were rolled forward using replacement cost. Even if Aer Rianta does not have such power, using replacement cost to revalue the RAB at each price review would lead to unstable charges. This is not in the customers' interests and it is difficult to see how inducing instability in the returns to shareholder funds reduces the cost of capital, as Aer Rianta claims.

The MMC's decision in the case cited by Aer Rianta favoured Ofgas' position and BG's asset base was revalued by indexed historic cost, not replacement cost. This is the practice in all UK regulated utilities. The cases Aer Rianta cites of asset revaluation in the UK were one-offs, not regular practice at price reviews. It is simply not true to say that replacement cost is the most common valuation base used in the UK for regulated industries. This applies only to one-off revaluations, for example at privatisation. Subsequent capital expenditure (which now accounts for more than half the assets in electricity distribution and transmission, for example) is rolled forward on an indexed historic cost basis, as we recommended.

This leaves open the issue of whether there should be a one-off revaluation of Aer Rianta's existing asset base. As we noted in our submission, capital expenditure has been so high in recent years that we would be surprised if there were any significant differences between using indexed historic cost and replacement cost for such a valuation. We therefore support the former, since it is not dependent on assumptions and predictions that would be hard for parties other than Aer Rianta to check.

8 Cost of capital

Aer Rianta has not submitted estimates of its own cost of capital. The issues it raises in principle seem to be intended to raise estimates of beta (the measure of risk) it faces. Some of these concerns appear to be over-stated.

It argues (8.2.1) that a single till approach increases the cost of capital by increasing risk. It is not obvious why. The variability of Aer Rianta's revenue is likely to be higher under its favoured dual till approach, since commercial revenue would vary with no countervailing movements in aeronautical revenues. The dual till may lead to increased risk compared to the single till, or it may have no effect (if the risk is diversifiable) but it is difficult to see how it reduces risk. Aer Rianta makes the point (in 8.2.2) that no sovereign guarantees are extended to the company's debt stock and consequently its WACC should be estimated as if it were a stand-alone business. We find it most implausible that the State would allow its sole airport operator to default. Unlike other

state-owned businesses, airports only compete with rivals in other EU member states in a very limited way and state aid provisions are unlikely to be applied. Consequently, Aer Rianta's cost of debt is lower than that faced by a private company or a state-owned company operating in EU-wide markets.

The State does not really accept a higher risk than the market would tolerate in order to guarantee this debt because its options for diversification are considerably greater than those of any private company. It faces no risk of going bankrupt itself and has regard for the interests of creditors as well as any debtors it may own.

Arguments about whether State support is a good or bad approach to running commercial activities, and the details of the degree of State guarantee are essentially irrelevant. The fact remains that financial institutions will be prepared to lend to Aer Rianta to fund investment at a rate well below market rates to similar private-sector enterprises. It would be perverse to allow Aer Rianta to make a return on those investments that significantly exceeds that rate.

9 Capital investment

9.2 Traffic forecasting

We are surprised that Aer Rianta has not involved us in its traffic forecast. We would like to see more information on the assumptions behind the forecasts. In particular, does the forecast for Shannon assume that the existing North American bilateral agreements remain in force unamended?

9.4 Current capital programme

We proposed in our submission that Aer Rianta should be forced by the regulator to pay more attention to its customers' views when planning new investment. We suggested that there should be a dynamic consultative forum, in which airport users were represented in rough proportion to their use of particular airports. We envisage this forum not as a talking shop but as an opportunity for users effectively to influence Aer Rianta's plans. In order to be effective, such a forum would either need powers conferred upon it by the regulator or the right to appeal to the regulator to intervene - with a strong presumption that some broad measure of approval by the forum is required before major investment projects can go ahead.

Aer Rianta refers to consultation in its submission. However, in our view consultation to date has been consistently inadequate. Without regard for the views of airport users, Aer Rianta has carried out gold-plated investment at all three of its airports. Aer Rianta appears to regard "consultation" as implying the collection of views from a very wide range of parties, before detailed plans are available for comment. It then proceeds to do whatever it wants, without regard for the views of its main customers: the major airlines operating from its airports. We note in this context that Aer Rianta has recently unilaterally attempted to abrogate an agreement between Aer Lingus and Aer Rianta, of 20th September 2000, on the ongoing development of Dublin Airport following the severe terminal congestion experienced last summer.

Up until the start of this year, Aer Rianta has neither sought nor acted upon our advice, during a period of major (and in many respects inefficient) construction. Perhaps in response to the problems last summer, it has set up the "Airline consultation process" as part of the process for future airport development. This is a step in the right direction but falls well short of the effective consultation needed to ensure that investment is timely and efficient. Aer Rianta clearly regards the exercise essentially as one of information gathering: we are to inform them of our requirements and they will decide what to do. We have not been presented with costed proposals, let alone alternatives, for comment. Without detailed investment proposals, and the power to influence decisions, this "consultation process" will do nothing to address the serious lack of co-ordination with airport users (and resulting inefficiency) that Aer Rianta has exhibited in recent construction projects.

We see nothing in Aer Rianta's submission to the Commission to suggest that it intends to become more responsive to its customers' needs. 9.5 Funding of capital investment programme

Generally, we note that throughout Aer Rianta's submission, it argues on cash-flow grounds for revenue to fund investment. We do not accept these arguments. Aer Rianta should be able to fund investment on the basis of expected revenue flows from that investment. If it cannot do this using internal funds, it should borrow: Aer Rianta has a solid credit rating, a strong asset position and implicit State backing. The regulator should set Aer Rianta's prices (and related decisions, such as the single-till/dual till issue) considering only the company's profitability, not cash flow. It would be inappropriate to charge customers more just so that Aer Rianta does not need to borrow.

In this section, Aer Rianta argues that assets in the course of construction should be included in its RAB. We oppose such "pre-funding" of investment. Charges should be levied only for services that actually exist, to reduce cross-subsidy between airport users in different years. Aer Rianta cites British Airways' support for this approach (without providing detailed references). We note that the pre-funding of Heathrow Terminal 5 agreed in the last CAA review was not a success. Airlines have paid higher charges for five years and construction has not started. British Airways has stated "Our experience with T5 pre-funding makes us wary of the concept of paying for major projects in advance" and, later in the same document "Past experience makes us wary of the pre-funding argument since it is difficult to earmark funds, and incentives to deliver the project on time are weakened significantly. These are major disadvantages to weigh against the advantages of smoother costs. In principle, there is nothing wrong with lumpy charges, provided that the increases coincide with tangible improvements in the quality of service. Most customers expect to pay more for a new and improved product."

10 Benchmarking

Aer Rianta concludes that difficulties in comparing airport costs and operations at an aggregate level are such that benchmarking should only be carried out for individual services. We accept that there are problems involved in rigorous "top-down" benchmarking but difficulties also arise from using service-level benchmarking for regulatory purposes. In particular, different airport operators may allocate costs or responsibilities differently across their various functions. This may lead to some activities being judged "super-efficient" (or inefficient), solely as a result of alternative

allocations. Extrapolating from such benchmarks to produce an overall picture of relative efficiency is therefore problematic.

Neither top-down nor service-level benchmarking is an exact science. However, the regulator can use his discretion in interpreting the results and can still gain useful information, even if a mechanical link from benchmarking through efficiency scores to the price control is not possible. We therefore urge the Commission to investigate some simple benchmarks of Aer Rianta's overall efficiency, in addition to any service-level benchmarks. We would be happy to advise and assist in either exercise.

11 Quality of service

11.1 Providing incentives for quality of service

We understand Aer Rianta's objections to incorporating detailed service quality measures in regulation. However, we do not conclude from this that service quality should not be incentivised. We argued in our submission for Service Level Agreements (SLAs) between Aer Rianta and airlines that would provide for meaningful financial compensation for performance below the agreed level. The regulators' backing is essential if we are to obtain such agreements, since Aer Rianta will not take such a step unless threatened with an alternative - such as direct regulatory intervention on service quality.

11.2 Service standards at Aer Rianta airports

The list of time-based service standards provided in Aer Rianta's submission illustrates its reluctance to commit to improving its own performance. Most of these standards are implemented by other parties (airlines and ground handlers are responsible for check-in, government bodies for passport control and immigration). We note that Aer Rianta provides no standards for activities that are under its direct control, such as:

- Access to the building;
- Road congestion;
- Baggage hall congestion;
- Functioning of baggage belts, airbridges and other facilities;
- Terminal cleaning;
- Ramp cleaning;
- Airside and landside snow and ice clearance;
- Passenger security processing including Fast track.

We have written to Aer Rianta requesting commitments to defined service quality measures and received no reply.

11.2.3 Standards for Third Party service providers

We do not accept that the service quality performance at Dublin in the past 18 months illustrates the

ineffectiveness of voluntary slot control procedures. As SH&E's report on airport capacity demonstrates, full co-ordination should not be required for an airport with this level of demand. In our view, the problems that have been experienced reflect Aer Rianta's inefficiency. We agree with Ryanair's comments on this issue, when they note that terminal capacity should be adequate for 20 million passengers and that better management could increase runway capacity by 10%. More generally, better management and timely completion of construction projects is the key to improved quality. This can be promoted by requiring Aer Rianta to consult effectively with airport users both on service standards and investment, as we stated in our submission.

12 Development of a new structure for airport charges

Aer Rianta's submission proposing a structure for airport charges once again illustrates their opposition to effective consultation. Airport users, especially airlines, need to be consulted on changes to the charging structure. They have not been in the past. Aer Rianta claims that it "has also consulted with its customers on the proposed charges structure". We dispute this statement. There are several entirely new proposals, or omissions from previous proposals, in the charging structure outlined in its submission. Later (12.4), it states "there have been no material objections from the airlines to the structure proposed and described in this chapter". We strongly dispute this statement and can provide correspondence in which we set out detailed objections to aspects of the charges.

Airlines must have an opportunity for detailed questioning of the arguments behind any such changes, once Aer Rianta has calculated the actual level of each charge. It is inappropriate to propose a structure such as this - without discussing the level of charges - at this stage in a regulatory review. We therefore do not comment on Aer Rianta's proposed charging structure and look forward to detailed consultation with airport users after the regulator has determined the overall revenue requirement that the charges intend to recover. We proposed such a consultative forum in our own submission on this issue.

12.8 Direct charging of passengers

Aer Rianta suggests that airlines would object to direct collection by the airport of passenger-related charges, since at present they receive cash-flow benefits from collecting those charges. As we noted in our submission, airlines in fact lose out by collecting these charges, since travel agents charge commission on the total ticket price, not the net fare. This effect greatly outweighs any additional interest earned in the gap between collecting and paying the passenger-related charges.

12.9 Peak pricing and long run incremental costs

We note that the three academic references cited by Aer Rianta in support of peak/off-peak differentials all relate to regulatory principles in general, not specifically to airports. As we noted in our submission, there is a good case to be made for such differentials if they induce substitution away from the peak. If they do not, there is no such case. As we discussed in our submission, academic commentators on airport pricing have usually recognised that the possibilities for substitution are weak, because of slot constraints at the airport in question and more generally

across an airport's network. For example, Doganis concludes that off-peak prices would have to be negative, to induce any significant effect. If premium prices for peak use do not result in any change of behaviour, they are simply discriminatory.