Submission of Aer Lingus to the Draft Determination on Maximum Levels of Airport Charges in respect of Dublin Airport (CP2/2005)

A. SUMMARY

This paper sets out Aer Lingus' response to the Commission for Aviation Regulation's (CAR) Draft Determination (CP2/2005) for the Dublin Airport Authority (DAA).

Our overall view is that the Draft Determination contains insufficient detail in many respects, particularly regarding the operational service levels or outputs of the capex programme for Aer Lingus to be able to accept any of the proposals contained in the Draft Determination. Moreover, insofar as we can judge the indicative maximum levels of airport charges presented, the figures are much too high. We believe that DAA must be set a challenging efficiency target combined with detailed performance targets and SLAs with effective penalties for performance failure. Furthermore, in the key areas of T2 and Pier D, there are too may unresolved details for these investments to be included in the current Determination.

The following is a summary of the key points we make in this document.

Price cap

- CAR's base case price scenario (scenario 1) is insufficiently taxing for DAA, as it permits the airport a price cap which is the equivalent of RPI+2 *before* taking into account the costs of expansion. We believe that a much more challenging base case is required.
- In addition, the profile of prices presented is not accepted, as it is suggested that charges should rise by 19% in the first year (2005 to 2006) then decline thereafter. Aer Lingus believes that this is not justified and the price cap should be smoothed to even price movements over the period of the Determination.
- We do not accept that DAA needs to receive an advancement of revenue for financial ratios. In general we do not accept the relevance of the FFO to net debt measure in a regulatory context. Moreover, CAR's own modelling suggests that when the debt from Cork and Shannon is removed no adjustment is needed anyway.
- Aer Lingus considers that there is no need to maintain a separate sub-cap for off-peak charges once Dublin Airport becomes slot coordinated from summer 2006.

The weighted average cost of capital

- CAR's estimate of the WACC for DAA of 7.4% on a real pre-tax basis is excessive. We take a different view of the Equity Risk Premium and DAA's asset beta, which leads us to consider DAA's WACC to be 6.1%. We believe this is a more appropriate rate of return for existing assets.
- We further believe that this figure exaggerates the efficient cost of capital for incremental investment. This is because a significant proportion of all future investment can be funded by debt on a limited recourse basis. This approach is both efficient in cost terms and protects the risk of equity from rising debt increases.

Pensions

- There is no justification for including additional pension costs in the Determination. Under the existing rules of the scheme DAA's pension fund is in surplus. A deficit only arises if DAA is seeking to enhance the benefits to its pensioners by guaranteeing CPI indexation. If DAA wishes to enhance the benefits to its staff it should do so at its own expense.

Capital investment

- There is a pressing need to define the capacity targets and formal service levels underpinning delivery of the plan set out in the Draft Determination, with appropriate penalties for failure to deliver against these targets.
- Aer Lingus also believes that the investment in T2, related infrastructure developments and Pier D need to be excluded from the current Draft Determination as there are too many details still to resolve.
- However, we make constructive suggestions about how this process can be taken forward and accommodated within the regulatory framework, including provision for logging up of expenditure agreed and incurred after the Determination, to ensure its funding at the subsequent price review.

RAB calculations

- We believe that it is wrong to allow investments that were inefficiently incurred in the past to be written back into the RAB. CAR's symmetry arguments are not persuasive and are contrary to regulatory precedent elsewhere. In competitive markets assets, that are not needed do not get remunerated.
- More creative should be given as to how the operations of T2 are organised and into how it is financed. In particular, we believe there is scope for third parties to provide a significant proportion of the functions within the new terminal, which would remove the need for these activities to be included within the regulated asset base.
- As regards Pier D, there is a serious risk that airport users are being asked to pay excessive amounts because of DAA's past failure to develop capacity

efficiently. There is a need for CAR to resolve this issue and decide what proportion of Pier D costs should be borne by DAA rather than by airlines.

- Aer Lingus also disagrees with the idea that airlines (and their passengers) should be expected to pay in advance for facilities that are not yet available to them. We propose a method by which facilities such as the new runway and terminal can be funded within the existing regulatory framework without seeking advance payment from airlines and without placing DAA at undue financial risk.

Operational performance

- Aer Lingus supports CAR's concern with measures of operational performance, but considers that it has not gone far enough. There is a need for more than simply monitoring performance against a number of benchmarks. There is a need for formal SLAs with meaningful penalties on DAA (or third party suppliers, as appropriate) for failures to deliver on promised services, where these penalties reflect the cost to airlines of DAA's failures.

Operating efficiency

- Aer Lingus believes that the plan for opex efficiency improvements by DAA is not nearly challenging enough. Examination of CAR' s base case indicates that there is little or no provision for efficiency targets to reflect the general increase in productivity in the economy as a whole or to encourage DAA to catch up with the efficiency frontier.
- The benchmarking evidence presented suggests that Dublin Airport is a long way from the efficiency frontier defined by its best comparator airport. Explicit efficiency targets should be set for DAA that are intended to make DAA reduce this efficiency gap over a reasonable period of time.
- Furthermore a general efficiency target needs to be imposed to ensure that DAA keeps pace with the general rate of productivity improvement in the sector as a whole.
- We believe that DAA should fund any real increase in wages out of productivity improvements. This is in line with regulatory precedent in other sectors.
- However, we also believe that a combination of "carrot and stick" should be used to encourage DAA to achieve greater operating efficiency. CAR should set DAA a challenging target, but also consider using some form of rolling out-performance mechanism that would allow DAA to keep the benefits of opex efficiencies over and above CAR's figures.

Our arguments on each of these points are set out in more detail below.

B. COMMENTS ON THE INDICATIVE MAXIMUM PRICE LEVELS

CAR is seeking views on the indicative price caps presented in its Draft Determination. Aer Lingus has reviewed these figures, and the modelling schedules in Annex 10.

Our general view is that all of the scenarios are far too generous to DAA. This results from a number of factors discussed in more detail below under our response to CAR's discussion of the statutory factors.

We are satisfied with the calculation of the price limits *given* the input assumptions of traffic forecasts and costs. However, as is detailed in later sections of this response we have serious reservations regarding CAR's assumptions on opex, capex, the RAB and the cost of capital. Moreover, we have a number of specific comments about CAR's scenarios.

We have also recomputed our own view of the appropriate charges by DAA under CAR's Scenario 1, reflecting our view of the appropriate opex target for DAA, WACC and profiling of charges.

We have more limited comments on the later scenarios because, as will be made clear in the relevant sections below, we reject both DAA's capex programme as it currently stands and the need for any advancement of cash flows for financial ratio reasons.

1. Detailed comments on CAR's scenarios

Scenario 1

We note that the average charge of €5.12 for this scenario is only 6% higher than the current charge for 2005 (€4.82). However, there are aspects of the calculation of this scenario which concern us.

The first is the profiling of prices, which show an increase of 19% from 2005 to 2006 (to €5.75) followed by a sharp decline. It is our view that there is no justification for a sudden movement in prices from 2005 to 2006. Any overall movement in prices (up or down) should be smoothed to provide a uniform rate of change of prices that generates the same NPV of revenue for DAA. We estimate that if CAR were to re-work scenario 1 to give a uniform real price movement per annum that delivered the same NPV of revenue then Scenario 1 is equivalent to RPI+2% per annum for five years.

We are obviously also concerned with the assumptions regarding opex and commercial revenue that underpin this scenario, and comment below in this submission on those factors. We consider it unfortunate (and unhelpful) that annual opex and commercial revenue figures are not given in the tables in Annex 10, although the NPV of the difference between the two is provided. The annual difference between the two numbers can also be inferred from the information in the two tables.

As regards commercial revenue specifically, we note that Annex 6 appears to suggest that commercial revenue could be expected to rise in line with passenger growth until 2009, with average revenues holding at €2.58 per passenger until then. We are not clear exactly what assumption has been adopted by CAR in practice, but in our view we believe that CAR may be underestimating the scope for DAA to increase its commercial revenues. We believe CAR should look again critically at this issue and should be benchmark revenues with those achieved at comparable airports. We note that evidence from the Manchester Airport Competition Commission investigation showed Manchester forecast to generate substantially higher revenues by 2008, in excess of £6 per passenger.

Given our reservations with the input assumptions in scenario 1, we have re-estimated CAR's figures using our view of the upper bound for opex that should be implied by the arguments presented in the Draft Determination and our view of the DAA's WACC (details of both are provided in the relevant sections below). We also consider that CAR is wrong to add back into DAA's RAB the value of investment that CAR describes as imprudent. As we do not have a quantification of this adjustment we have left DAA's RAB unchanged in our calculations, but as a result our figures are subject to the caveat that prices would be even lower if the imprudent investments were also struck from the RAB as we think is appropriate.

Our estimates include a 3% real productivity improvement (1% general productivity plus 2% catch-up). We find that on this assumption the correct average price for DAA over the five years to 2010 should be €4.30 *if* DAA is allowed to retain a 3% p.a. allowance for wage inflation and €3.85 if it is not allowed wage inflation. Our view is that regulated firms should not be allowed to build real wage inflation into their cost estimates. This view is consistent with regulatory precedent, including the treatment of BAA and Manchester Airports at their most recent price review.

The first of our scenarios is equivalent in NPV terms to a smoothed annual price movement of RPI-6. The latter (excluding wage inflation) is equivalent in NPV terms to a smoothed annual price change of RPI-10. It should be noted however that both of these scenarios exclude the costs of expanding capacity, and merely provide, in our view, an appropriate base line to work from.

We believe these figures indicate that CAR's base case, which is equivalent in NPV terms to a smoothed price rise of RPI+2 (before allowing for any capacity opex) is far too generous to DAA.

Scenario 2, 3 & 4

For reasons we have outlined below, Aer Lingus does not accept DAA's projections for capex, or for the WACC. We think therefore that the results of these scenarios provide no useful guidance for CAR's Draft Determination.

We note with concern however that comparing scenarios 2 and 1 the difference between opex and commercial revenue grows by €58.1m from €80.3m to €138.4m. This difference amounts to an additional increase in opex of 30% over and above that allowed for growth in the base case. Given that in our view the

CAR's base case is already over-generous, we draw the conclusion that the opex forecasts in DAA's plan lack credibility.

Scenario 5, 6 & 7

These scenarios present financial figures for DAA after advancing depreciation to improve DAA's financial ratios. It is our understanding that the *only* ratio that justified this sort of adjustment was the ratio of funds from operations (FFO) to net debt. Other financial ratios, including standard account ratios such as interest cover and other cash-based ratios did not appear to generate an "issue" for DAA.

However, Aer Lingus does not accept that there is a need to profile DAA's charges for financing reasons.

As matter of principle such an adjustment is not needed, because DAA's long-term debt cover is guaranteed by the nature of the regulatory process. FFO to debt ratios are relevant to financial institutions because there is a risk with unregulated companies that interest costs will rise but that prices will not. Hence even if current cover ratios are adequate it is possible that in the future the company will not be able to cover its repayments. However, this situation cannot arise with DAA. As a regulated company, if interest costs rise, CAR will increase DAA's WACC to compensate and this will be passed on in higher prices. Hence the regulatory process ensures that, provided it is well managed, DAA will always be able to meet its financing requirements.

By way of support for Aer Lingus' view, we note first that we are unaware of any regulatory precedent for using this measure to adjust regulated cash flows. Furthermore, the Water UK investor survey conducted for the UK review of water price asked about the most important financial ratios. The results of this survey identified cash interest cover and the debt to RAB ratio as the most important (to both debt and equity investors). Debt investors also thought that the ratio of cash flow to capex was important. However the ratio of cash flow to net debt was considered less important by all investors.

We conclude therefore that there is no objective justification for adjusting DAA's cash flows in order to meet a specific short-run target of FFO to debt. As a consequence we reject the relevance of scenarios 5 and 6. We note that the implied annual rate of return on the RAB in scenario 6, when the excess depreciation is taken into account, is around 13%. Clearly there is no justification for DAA generating this sort of annual level of profit, even in the short term.

Moreover, we find it revealing that scenario 7, in which Dublin is treated as a stand alone activity, shows that the FFO: Debt adjustment has no impact on DAA's charges. We believe that this is the correct conclusion.

It should be noted that the legislation only refers to the need to enable the DAA to operate and develop Dublin Airport "in a sustainable and financially viable manner".[1] It is therefore not appropriate to reflect the finances of the entire

[1] Section 33(1)(c) of the Aviation Regulation Act 2001 as amended by the State Airports Act 2004.

group in DAA's charges. Neither losses nor debts incurred outside of the operation of Dublin Airport should be taken into account in setting prices at Dublin. In particular, debts within the group should be allocated where they are generated (i.e. to Cork and Shannon or appropriate).

2. The sub-cap for off-peak charges

CAR requests views on the continuation of the sub-cap for off-peak charges.

In response, Aer Lingus notes that from summer season 2006, Dublin will become a coordinated airport. After this point the allocation of airlines to new slots will be dealt with by the slot coordinator. As a consequence airlines will not be in a position to respond to peak/off-peak price signals by choosing their slot times to the same extent as in an uncoordinated airport.

As airlines cannot respond to price signals in the new coordinated regime, we believe that there is no continued function for maintaining a separate sub-cap for off-peak charges. Indeed we believe that under the slot managed regime, Dublin Airport should charge a common price for all slots and not discriminate between peak and off-peak. We believe this is consistent with precedent elsewhere. We do not know of any coordinated airport charging differential peak and off-peak landing charges.

3. Other comments on pricing

CAR does not discuss the issue of the structure of DAA's pricing except in the context of the off-peak. Aer Lingus, however, wishes to put on record its views in relation to any discrimination in prices as between the users of different facilities within the airport. For instance, as regards charges to users of T1 and T2.

We believe that CAR should concern itself with ensuring that if DAA chooses to price differentiate between airlines it does so on a non-discriminatory and cost-reflective basis.

Clearly if T2 were to be provided (for argument's sake) as a shell, with terminal services provided by third parties, then it would be reasonable for the charges made to users of the two terminals to be different. But this difference must reflect true differences in the cost of the services provided. It is essential that users of T1 should not subsidise costs in T2 and it must be made clear that this would not be permissible under any price cap set by the CAR.

C. COMMENTS ON CAR'S DISCUSSION OF STATUTORY FACTORS

The Weighted Average Cost Of Capital

CAR relies for its view on DAA's WACC on the paper by Kearney and Hutson presented as Annex 5 of the Draft Determination. This concludes that DAA's WACC is 7.4% on a real pre-tax basis.

Generally speaking, we consider this paper to be very strong, theoretically robust and well supported with evidence. Nonetheless we consider that it overestimates DAA's WACC. There are two reasons for this. Firstly, we believe the authors overstate the value of the Equity Risk Premium and DAA's asset beta. Correcting these values, we believe that the appropriate WACC would be 6.1% on a real pre-tax basis. However, in addition, we believe that the authors do not pay enough attention to the scope for the use of modern and innovative financing methods for new airport investment. As a consequence, there is substantially more scope for financing new investment purely from debt than is envisaged, and this can be achieved *without* a compensating increase in the cost of DAA's equity. As a result, in our view, while 6.1% represents a reasonable return to DAA on its existing RAB, the *marginal* cost of capital on additional investment should be significantly lower than this figure.

(a) The WACC For existing assets

Aer Lingus agrees that the capital asset pricing model is the appropriate basis for assessing the cost of capital for DAA's existing assets. We also agree with the authors' estimate of the risk-free rate.

However, Aer Lingus believes that the assumed equity risk premium (ERP) estimate of 6% is too high. The analysis by Dimson, Marsh and Staunton (DMS) shows that the average ERP for a world index, comprising 16 countries, over the period 1900-2000 is 4.6% using a geometric average and 5.6% using annual arithmetic averages. If there is any mean reversion in equity returns then the annual arithmetic average would overstate the appropriate forward-looking ERP. The DMS dataset shows that the arithmetic ERP on the world index over rolling ten year periods is 4.7%. This indicates that there is mean reversion in equity returns and this evidence would suggest an ERP value of around 5% is appropriate. We also note that the UK Competition Commission in the UK used a value of 3.5% for the ERP in the calculation of the cost of capital for BAA.

We agree with the assessment of an asset Beta of 0.5 for BAA. However, we do not accept that this should be increased by 20% to give an asset Beta for DAA. The analysis identifies a number of factors that may support an uplift: DAA has higher business risk as evidenced by a lower credit rating, the Irish economy is considered riskier than the UK economy, the possibility of downside risk, uncertainty surrounding the construction of the second terminal, and DAA will be less diversified than Aer Rianta. Aer Lingus is not persuaded by these arguments. In particular:

- **credit rating** - the lower credit rating can be explained by DAA currently having a higher level of gearing than BAA;
- **risk of the Irish economy** - equity investors are increasingly diversified across international markets and do not need to take account of any higher specific risk in the Irish economy;

- **downside risk** - the analysis in the paper shows that airports are not subject to significant asymmetric risk. Indeed the authors comment on this, yet make an allowance for asymmetric risk anyway;
- **uncertainty regarding second terminal** - it is not clear that DAA is subject to more uncertainty regarding construction and legal challenge than BAA is. Furthermore, as we note elsewhere, the uncertainty surrounding T2 needs to be resolved before the project can proceed, hence DAA's WACC cannot reflect uncertainty that will by definition have to be resolved; and
- **less diversification** - the fact that DAA will be less diversified than ART should not affect the returns required by equity investors, who will themselves hold diversified portfolios.

Overall we consider that an unadjusted asset Beta of 0.51 for DAA is appropriate.

Taken together, these factors imply a WACC of 6.1% for DAA on a real pre-tax basis. The calculation of this figure is shown in Table 1 below:

Risk-free rate	2.60%
Debt premium	1.10%
Cost of debt	**3.70%**
Risk-free rate	2.60%
Equity premium	5.00%
Asset Beta	0.51
Equity Beta	0.89
Cost of equity	**7.05%**
Gearing	46%
Tax	**12.5%**
WACC pre-tax	**6.1%**

Table 1: Aer Lingus'estimate of the WACC for DAA

(b) Funding of incremental investment

CAR's approach is to assume that the WACC applies equally to existing assets and to incremental investment at Dublin. We believe, however, that this approach fails adequately to reflect the opportunity to take advantage of innovative methods of providing debt finance to develop airport facilities. As a result, even the lower WACC figure we have estimated above overstates what we believe to be the true marginal cost of funding additional investment.

Kearney and Hutson note in their paper that additional investment is likely to be funded by debt. We accept, however, that under the conventional WACC analysis, the fact that incremental funding is purely debt does not mean that the marginal cost of capital equals the cost of debt alone, as increased gearing increases the equity beta, which in the low tax Irish context tends to offset the benefit of higher gearing.

CAR, however, is failing to appreciate the scope for the use of limited recourse debt to fund individual projects or activities within an airport, and thus obtain marginal funding at rates well below the WACC without raising the cost of equity. Limited recourse debt involves the lenders taking on some of the project risk. This is achieved by ring-fencing the debt to a particular project (for instance the baggage handling system) and linking repayments to some metric of performance (e.g. bags carried, passengers served) rather than a fixed repayment schedule. In this way the lender takes on some of the project risk in terms of the length of time over which repayment will be achieved. The premium for such debt will be greater than the bond premium discussed by Kearney and Hutson, (perhaps 2% rather than 1.1%), but this will still leave the marginal cost of capital well below the WACC for existing assets. Furthermore, because recourse for the lender is limited to the specific project, the riskiness of existing equity is not increased in the way envisaged by the conventional WACC calculation.

In our view there are many aspects of DAA's investment programme that could be funded in this way including T2 as a whole or individual aspects of the development such as car parking, baggage handling and screening, check-in facilities or refuelling infrastructure.

D. PENSIONS

DAA has indicated to CAR that it envisages the need to increase pension contributions, and CAR seeks views on this matter and how such an increase should be funded *if* the need is accepted.

Aer Lingus' view is that the rules of DAA's pension scheme (which is a multi-employer scheme shared between Aer Lingus, the DAA and SR Technics (formerly Team Aer Lingus)) are clear. Under this scheme both employer & employee contributions are fixed at 6.375% of salary and there is no obligation on either the employers or the employees to vary those contributions regardless of the actuarial position of the scheme. Importantly, with regard to benefits, there is no guarantee of CPI indexation contained in the rules.

As the most recent actuarial report reveals, there is no deficit in the pension scheme. We can only assume that DAA's case for increasing contributions is based on the assumption of guaranteeing CPI indexation (which does not reflect the current rules) in which case the scheme would be in deficit. However, as the existing scheme does not guarantee indexation, to make such a guarantee would clearly represent an enhancement to existing scheme rules. It is clearly open (in principle) to the DAA to make such an enhancement, but if they were to make such a decision there is no case whatsoever for their customers to bear the cost of the enhancement. As a consequence, in our view, there is no justification for allowing increased pension contributions in DAA's price limits.

From a practical perspective we note that DAA is only one of three participants to the existing pension scheme. As such, it is not open to DAA in practice to enhance benefits to its pensioners without agreeing this increase with the other participants. This, we assume, is the reason underlying DAA's desire to establish a new, independent pension scheme.

Such a plan, however, makes it clearer that DAA is seeking to enhance benefits at its customers expense and demonstrates why such costs should not be allowed in prices. If DAA were to proceed with creating a new pension scheme and transferring its members (pensioners, deferred pensioners and current staff) to the new scheme, it would require the actuary of the existing scheme to divide its assets between DAA and the other participants. If the DAA were permitted to recover any initial deficit which may arise in its new scheme resulting from the actuary's division of existing assets, it would have no incentive to press the actuary for the best possible allocation of assets. This cannot be appropriate. Hence we conclude that any deficit experienced by DAA in its pension as a result of choosing to enhance benefits should be funded by DAA alone, regardless of whether DAA establishes a new pension scheme.

We note that CAR separately seeks views on how additional pension costs should be recovered through charges *if* such a step were necessary. Without prejudice to Aer Lingus' position that there is no justification in passing through additional pension costs in airline charges, we are of the view that such adjustments, if they must be made at all, should be made through opex not through the RAB. There are two reasons for this: first pension costs are a personnel cost not an investment item, hence more appropriately dealt with via opex. More importantly, while pension liabilities relate directly to DAA under the present scheme, assets are pooled and cannot be allocated in this way. Hence it is not possible to allocate the specific net value of assets of the DAA as distinct from the other members of the scheme in the absence of a transfer to a new scheme.

E. DAA'S CAPITAL INVESTMENT PROGRAMME

DAA's plans for capital investment at Dublin Airport are set out in Annex 7 of CAR's Draft Determination. We note that DAA's 10 year capital plan amounts to more than €1bn, with almost €600m of capex scheduled for the period 2005 to 2009.

DAA has stated that airline users acknowledge the need for additional capacity at Dublin Airport but oppose the charge increases implied by the required investment. By making this statement it appears that DAA is painting the airlines as being unreasonable and attempting to bypass their opinions in setting the appropriate level of capex for the next regulatory period.

The opposite is in fact the case. Aer Lingus recognises the need for additional capacity investment at Dublin Airport and is, of course, willing to pay appropriate charges reflecting the cost of this investment. However, there are a number of vital conditions that must be met before the scale of DAA's investment programme can be agreed.

- ***Investment must be linked to clear measures of output (e.g. capacity to be provided) and operational service level agreements (SLAs)***. The airlines, as customers of DAA. Must have clear and binding agreements with DAA with respect to what they are receiving in return.
- ***Investment must be funded efficiently.*** DAA's plan clearly entails that all investment at Dublin Airport should be undertaken by DAA itself, capitalised in its RAB and, therefore, adding to DAA's equity. Aer Lingus believes that in many cases investment at Dublin is more efficiently funded outside the RAB.
- ***Investment should be only be reflected in charges once that investment is in use for the benefit of passengers.*** This should mean that charges do not rise simply because the costs of capacity intended for a larger number of passengers are being recovered in advance from fewer passengers who do not need, or are not benefiting from that capacity. Furthermore, the costs imposed on airlines for disruption caused during construction of new facilities for the benefit of all should be factored into the costing of DAA's schemes.

If investment is efficiently specified and funded it does not follow that that charges *per passenger* need to rise as a result of this investment to expand capacity. If DAA can demonstrate that incremental costs really are increasing, even after meeting the above criteria, then Aer Lingus accepts that it is possible that charges per passenger could increase. But we remain to be convinced that this is actually the case at Dublin Airport.

Because neither of the first two conditions is met by DAA's proposals, Aer Lingus cannot at this point agree with the inclusion of any expansion investment in the Draft Determination. Our third point, relating to the relationship between investment and the RAB is a matter for CAR's regulatory process. We deal with this in a later section.

(a) T2

DAA's failure to specify appropriate capacity measures, SLAs and efficient funding mechanisms is most clearly reflected in its proposals for T2, for which DAA is seeking an allowance of €180m, almost 20% of its 10 year investment plan.

In terms of the service provided by T2, DAA cannot yet provide detailed plans to the airlines regarding such key matters as:

- where T2 will be located;
- what the capacity of T2 will be in terms of passenger throughput, aircraft stands, etc.;
- the provision for aircraft contact stand expansion and the location of Pier D;
- what the capacity of internal systems will be, including check-in, baggage handling (inbound and outbound) and screening, passenger security screening, etc.;
- whether there is the option for sole occupancy of the new terminal, in which case whether the tenant could take responsibility for fitting out and operating the terminal itself;

The need to clearly specify capacity is paramount if airlines are not to pay repeatedly for the same capacity. By way of example, we can cite the six-bay extension to T1, which was included in Dublin's agreed capex plan and capitalised into the RAB on the understanding that it would provide significant additional capacity. It now emerges that this development has failed to deliver the promised increase in passenger throughput / numbers. This failure to deliver promised capacity is not unconnected with DAA's now pressing need to develop Pier D (see below), capacity for which the airlines can justifiably claim they have already paid and should not pay for again.

Returning to the issue of T2, a terminal building is not a simple asset with a generic specification. It is rather a complex amalgam of structures and systems designed to facilitate the departure and arrival of passengers. The specification of each part of the building and the systems it contains can have a dramatic effect on the service that the terminal building will provide to the airlines that are using it. Aer Lingus cannot agree that €180m is or is not a reasonable investment in T2 without a detailed specification from DAA as to what T2 will provide.

Furthermore, Aer Lingus needs to understand the SLAs that DAA is willing to enter into with regard to the new terminal and that the penalties for failure to deliver against those SLAs are effective. For SLAs to be both fair and effective, the penalties imposed must reflect the costs imposed on the airlines by DAA failing to meet its agreed level of service. The Draft Determination of these SLAs is equally important to Aer Lingus in assessing the value for money of DAA's proposals.

Moreover, Aer Lingus disagrees with DAA's concept of T2 as being an asset owned and operated in is entirety by DAA. We do not believe that this model is conducive to the efficient operation of T2 or to the efficient financing of this investment. In our view the terminal as a whole or many elements of the terminal infrastructure can and should be provided by third parties as independent and self-financing projects, taking advantage of limited recourse debt financing as described above. The sub-elements of a terminal that could be independently financed include, among other aspects:

- check-in desks and computerised system;
- baggage handling infrastructure
- hold baggage screening; and
- car parks.

Where appropriate, the airlines should contract directly with third party providers. The services can be paid for directly by airline users and be subject to detailed SLAs with binding and effective penalty mechanisms for performance failure.

Funding operations in this way means that they do not need to be included in CAR's initial price Draft Determination and do not form part of CAR's RAB. The debt markets have shown that they have an appetite for lending to this kind of infrastructure project and that finance can be obtained on very favourable terms, because of the secure nature of the cash flows associated with a regulated airport.

The funding of individual elements of terminal infrastructure is not the only area that DAA has to address before T2 plans can be agreed. Aer Lingus believes that DAA should consider alternative funding options for T2. For instance, DAA and Aer Lingus (or Ryanair for that matter) could discuss an exclusive use and long term occupancy agreement for the new terminal. In such case, we might propose that Aer Lingus would not only control the fitting out & equipping of the terminal but also the construction of the building (under the supervision of DAA) and its financing (including structured financing if available) with the building reverting to DAA after a reasonable period (say 20 years).

It is clear that the complexities surrounding the specification and financing of T2 cannot be resolved within the timetable that CAR has to set charges for DAA. Moreover, in light of the Minister's requirement on T2 that prior consultation take place with the airlines and that final specifications and costings be independently verified by aviation experts, T2 should be excluded from the allowed investment plan at this stage, and any related opex should also be removed from the final Determination. Attention then needs to be given to:

- agreeing the capex costings and opex projections, specifications (including capacity) and operational SLAs surrounding T2 within a reasonable timetable; and
- a mechanism to allow capex (and opex) legitimately agreed and undertaken by DAA on T2 to be capitalised into its RAB and (ultimately) recovered through airport charges.

We discuss this matter in more detail below.

(b) Pier D

In addition to concerns regarding the financing of T2, Aer Lingus also has concerns regarding the sums included in DAA's plans for Pier D. These concerns are sufficiently strong that we believe that the capex and opex implications of Pier D should also be excluded from the Determination at this point, and then made subject to the same type of agreement mechanism as discussed for T2 above.

DAA's plans show that Pier D is scheduled for completion only two years before T2 commences operations. As a result, if T2 is located in the proposed southern location (see further below), it is possible that Pier D would only have two years of efficient operation before the introduction of T2 makes it, if not redundant, then certainly substantially under utilised and/or inefficient for its users.

While we accept the need for Pier D as a short-term fix to the existing capacity problems at Dublin, this situation has come about because of Dublin Airport's persistent failure to make progress with necessary capacity projects in the past few years. The airlines and their passengers are already paying the price of this failure in the congestion and delays experienced at Dublin.

As a consequence of past failures DAA's future capex plans (including the six-bay extension) involve an inefficiently high level of cost being imposed on passengers in Dublin, which should rather be borne by DAA as a penalty for the company's inefficiency.

Furthermore, because DAA's inactivity has now forced them into this stop-gap approach to capacity, it may not be possible to properly coordinate the development of Pier D and T2 in the most efficient manner. This is particularly true because the location of T2 is not yet decided. With the northern location of Pier D, a later choice of a southern location of T2 would exacerbate the inefficiency and further raise costs. We believe that passengers should be protected from any such increase in costs, which are the direct result of past inefficiencies in the development of new capacity by the airport operator.

We accept that some of the costs of Pier D should be met by passengers, but before capex and opex can be included in the final Determination, an agreement needs to be reached regarding the proportion of these costs which should be met by DAA as a reflection of its past inefficiencies. This is a decision that DAA and the airlines cannot be expected to agree between themselves. Rather, the intervention of the Regulator is needed to make such a decision.

F. RAB ISSUES & ADVANCING FUNDING OF RUNWAY/TERMINAL FACILITIES

CAR's Draft Determination raises several issues around the calculation and rolling forward of DAA's RAB and seeks views. Our concerns are as follows:

- We are concerned at CAR's suggestion that inefficiently incurred investment made in the past should be written back into the RAB. We believe this is not justified and is contrary to regulatory precedent.

- T2 (and other capacity investments) present difficulties because, as yet, they are insufficiently well costed to form part of the price Draft Determination. Progress needs to be made before the next Draft Determination, which means a mechanism is needed to ensure that DAA is remunerated for (appropriate) investment in T2.
- However, Aer Lingus believes it is also important that airlines (and through them their passengers) are not made to pay for capacity before that capacity is actually operational. A solution to this is required in the regulatory formula.

(a) Rolling capex adjustments & writing back inefficiently incurred investment

CAR argues that customers should not continue to pay for investment that was included in the previous Draft Determination but was not carried out. It also argues that, for symmetry, past investment that has been disallowed should be added to the RAB at the next price review. Aer Lingus agrees with the first of these points and CAR should note that historically Aer Rianta has not carried out expenditure in line with its proposed capex plan. However, Aer Lingus strongly disagrees with the second point for the reasons set out below.

We believe that CAR should institute a formal rolling adjustment mechanism in the RAB, similar to that applied by Ofwat in the UK. This process means that DAA would be able to retain the benefit of any capex efficiencies for a fixed period (in the UK this is five years) regardless of when the efficiency is achieved. This process mirrors the functioning of a competitive market in which efficiency is rewarded in the short-term, but in the long term is competed away as rivals catch up and reduce their prices.

However, this rolling adjustment process should not be confused with the need to adjust DAA's RAB for investments that have been imprudently undertaken or not carried out at all.

Under Ofwat's system, if money is included in a company's capex plan for a particular output and that output is not delivered by the next price review then this saving is *not* viewed as an efficiency saving. It is viewed as a failure to achieve agreed outputs. In these circumstances the company's RAB is immediately adjusted downwards by an amount the regulator considers appropriate. Potentially this adjustment could equal the full amount of the capex that was allowed in the first place.

Moreover, the rolling adjustment of the RAB does not require that inefficiently incurred capex be written back into the RAB at some future date. To do so would clearly be wrong. As with efficiencies, the correct treatment of inappropriate investment can be judged by the benchmark of a competitive market. If a firm in a competitive market invests in something that is not needed or over-specified or that customers do not want then they cannot recover *any* of the cost of that investment in the short-term or in the long-term. What CAR proposes would mean that in the long-term passengers at Dublin would share the cost of DAA's mistakes. Competitive markets do not work in this way; hence it is not necessary, or desirable to make such an adjustment to DAA's RAB.

We further note that Aer Rianta has in the past used its funds to acquire a series of non-core assets, not related to the functioning of the three airports for which it was responsible. In our view, rather than adding the value of inefficient investments to the RAB at Dublin airport, they should be financed through the realisation of value (through sale) of some or all of its non-core assets. The justification for doing so is that its funds were boosted from regulated income by Aer Rianta's past under-investment.

(b) T2

We have identified above that there is a need to exclude T2 and other related infrastructure enhancements from the Draft Determination because the scale and timing of the investment is uncertain, SLAs need to be clearly defined and the method of financing the development (including the division of activities between DAA and third parties) has to be resolved.

We recognise that this leaves DAA in a difficult position, because if capex is not included in the Draft Determination then it is not clear that DAA will be remunerated for it. On the other hand, if DAA waits until after the *next* price to commit to major investment then the process will be unnecessarily delayed.

We suggest that the solution to this problem also lies with the approach that the UK water regulator has taken to what is called "logging up". Under this approach the regulator can formally recognise expenditure that is undertaken between reviews so that it will be reflected in the following Draft Determination. This can be done by the issuing of a letter by the regulator specifying the sum involved and guaranteeing that the sum will be included in the RAB at the start of the next regulatory period.

This procedure is different from allowing DAA to capitalise its actual spending on T2 in the RAB. Under logging up DAA would be subject to the same incentives to be efficient on the logged up investment as it would be on the investment included in the Draft Determination. If, on the other hand DAA were simply allowed to accrue in the RAB any amounts it spent on T2 then there would be no incentive for it to incur this investment efficiently. This would clearly be undesirable and, we would argue, would also be contrary to the CAR's objectives.

In formal terms, the process for agreeing such logging up could be relatively simple. DAA and the airlines need to agree the details of T2 as discussed above. At this point DAA needs to submit a written request to CAR for the investment to be logged up. CAR need then satisfy itself that the figures are reasonable, which should be straightforward if DAA already has the airlines' approval, and issue a written commitment to log up the investment at the next review. However, we are concerned that there may be significant practical difficulties that need to be addressed.

There are similarities with the process we are suggesting and the "constructive engagement" proposed by the CAA in the UK between BAA and the airlines before BAA finalises its business plan for its next price review. However, while this process has some merit it is untried in the UK. Furthermore, given the track record of "consultations" with Dublin Airport, Aer Lingus is justifiably wary of the extent to which DAA would engage openly and cooperatively in such a process. As CAR is well aware, Dublin Airport has not, in the past, been in the habit of providing airlines with the level of detail required for them to take informed decisions on the airport's plans.

Furthermore we are concerned that the burden of agreeing DAA's plans will fall disproportionately on Aer Lingus if CAR were to leave matters to negotiation solely between DAA and the airlines. Aer Lingus is not a large operation and functions on slim margins and limited resources. We cannot afford to devote substantial resources to vetting DAA's plans if the airport is not forthcoming with the necessary level of detail. We are also doubtful that other major carriers at Dublin would participate cooperatively in the process. Consequently, we do not believe that CAR can simply leave matters to "constructive engagement" in the way CAA has proposed in London where the carriers concerned have much greater resources at their disposal. Rather CAR needs to initiate a "Tripartite" process between regulator, airport and users (via the AOC) to determine the plans for airport expansion and agree costings and SLAs. CAR's role in this process will have to be central: chairing the meetings and driving on DAA to provide the necessary detail to permit airlines to sign up to DAA's plans. The incentive for the other parties to cooperate will be that without doing so necessary capacity expansion at Dublin will be further delayed.

Finally, we note that the logging up process described above would not allow DAA to increase its prices between reviews. We consider that this is appropriate given the nature and timing of the investment concerned, as we will describe below. Nor would it allow DAA simply to capitalise what it had spent into the RAB, as the logged up amount would represent a cap on the allowable capex that could be included in the RAB.

(c) The timing of price increases

Aer Lingus believes that it is contrary to CAR's objective to promote efficiency to allow the cost on investments that are not yet operational to feed through into current prices.

In competitive markets, firms cannot charge in advance for new capacity they are building or new products they are developing. The same should be true for DAA.

However, we do not consider that this proposal presents any problem for the financial stability of DAA, because there is a very simple approach that CAR can adopt. CAR should calculate the RAB in two parts: the fist part is the value of operational assets, on which DAA should be allowed to generate a return in that year. The second part should represent work in progress (WIP): assets that are under construction or not yet operational. Revenue in the year should not be affected by this WIP value. Rather DAA should ensure its return on this investment by the way in which the WIP value is carried forward in the RAB. First, it should not be subject to any depreciation charge. Secondly, the WIP should be carried forward from one year to the next by inflating it in real terms plus the capitalised return on that WIP asset at DAA's WACC that has not been remunerated that year. When the asset becomes operational the full value of the WIP should then be transferred to the "active" RAB.

This procedure guarantees DAA a return on its WIP just as it earns a return on its RAB, but ensures that this return does not impact on prices until the asset becomes operational. Furthermore, as capex is not transferred from the WIP amount to the RAB until commissioning, this proposal allocates the commissioning risk firmly where it belongs, with DAA.

(d) Importance of operational performance

CAR correctly identifies that measurement of operational performance is vital. We agree that CAR should monitor DAA's performance. However, we believe that CAR should go further than simply monitoring. CAR's Determination should be explicitly linked to the achievement of specific targets by DAA against a number of key performance indicators for new and existing facilities. These targets should be embodies as explicit SLAs with effective penalties that reflect the cost to the airlines of DAA's failure to meet the necessary service levels.

As stated above, the exact specification of the target levels and the penalty mechanism needs to be agreed in a tripartite forum between DAA, and the AOC with the chair held by CAR so that it can drive the process.

In terms of the indicators that should be included, Aer Lingus agrees with all the elements of the list set out on page 51 of the Draft Determination. We also believe that the reliability and availability of the CUTE check-in system should be added to this list. For the avoidance of doubt, the hold baggage screening system should be included within outgoing baggage systems. Also the needs of passengers with reduced mobility should be expanded to also encompass those with hearing or visual impairment.

As regards the measures on which CAR should focus, with respect to contact stands, check-in, security and other equipment, the key measures for airlines relate to the maintenance and enhancement of the annual and peak hourly flow capacity of all facilities.

G. COST COMPETITIVENESS

At point 7 on page 51 CAR refers to its duty to seek the cost competitiveness of Dublin Airport, and refers to Annexes 4 and 11 in this regard as providing the material for its determination.

We have reviewed the analysis that underpins CAR's assumed opex for DAA in its Draft Determination and have a number of serious reservations regarding the robustness of the analysis and the way in which the evidence presented by CAR has been applied.

In the most general terms we consider that the initial level of opex allowed DAA for 2006 is too high and that the efficiency targets applied thereafter are insufficiently challenging. We are concerned that:

- BAH's "Bottom-Up Efficiency Study" does not present a robust case supporting the initial level of DAA's opex, nor does it appear to contain a systematic analysis of the potential for efficiency improvements. The efficiency improvements identified in that report seem to be, by any standards, very small indeed.
- It is not clear what weight CAR has placed on the TRL and ATRS reports, described in annex 11, in its Draft Determination. These reports indicate that, based on international comparisons, DAA may have significant scope to reduce its costs.

(a) Annex 4: BAH Report

We consider that BAH's bottom up efficiency study for DAA fails either to provide robust support for the current level of opex or to provide a proper analysis of the scope for future efficiency improvement.

In the first place the report does not appear to have any clear methodology for analysing the data that it presents. The analysis of existing operations is an aimless meander through a series of unconnected facts, many of them irrelevant to determining the appropriate level of DAA's opex. Capacity issues and the poor design of some parts of Dublin Airport's infrastructure are discussed without any clear explanation as to their relevance to the matter at hand.

We note that on page 5 BAH rejects the possibility of benchmarking. We feel that this hostility to the use of comparisons undermines the usefulness of BAH's work. As a consequence their report lacks any objective analysis of benchmarks to assess the level of DAA's costs and the potential for efficiency improvement.

We do not agree with BAH's simplistic dismissal of benchmarking. We recognise that there are significant difficulties in performing systematic comparisons at the aggregate level. However, as is demonstrated by the analysis from TRL and ATRS presented in Annex 11, use of a range of different comparators can generate a consistent and useful pattern as regards the relative costs of different airports. Moreover, while BAH's criticism of benchmarking applies to top-down analysis of costs, it does not apply to the comparison of processes between airports in a bottom-up analysis. Yet BAH present no such process comparison. As a consequence it is not possible to infer how BAH has reached its judgements that very largely endorse DAA's cost projections.

By way of illustration we can highlight one inefficiency on the part of DAA which has had massive knock on implications on passengers and on DAA's investment plan and yet is an issue that passes completely unnoticed in BAH's review.

The matter is that of security screening. From mid-April 2005, security screening has been tightened at Dublin to a degree unusual at almost any major airport. This tightening was a response to an EU audit of DAA's security screening procedures and it became apparent that the existing facilities were inadequate. There are two knock on consequences of this tightening of security.

First, DAA has historically failed to invest in the infrastructure necessary to expand screening capacity to allow for an efficient and effective passenger profiling system. As a consequence, queues for security screening have become excessively long. This leads to additional congestion in the terminal, and has forced airlines to increase their minimum check-in times from 30 minutes to 45 minutes, which further increases terminal congestion. Moreover, as news of the "chaos" at Dublin spreads among passengers, we are seeing increasing evidence of passengers arriving even earlier for their flights. This adds still more people to the terminal at peak times and further exacerbates congestion.

The second impact of DAA's failure directly affects its plans for future capex. Because of the congestion described above passengers are seeking to pass through security screening earlier and earlier. This has lead to a fall in retail revenues from land side outlets and a substantial increase in demand for particular food outlets on the air side of security, where there is currently very little provision. Consequently DAA's commercial revenues are hit and planned investment increases, all as a consequence of DAA's failure to provide adequate security screening capacity. Hence, all these additional costs of congestion which have forced Aer Lingus to remodel some of its ground procedures to avoid unnecessary delays to its customers and operations together with the refurbishment of the terminal, stem from an original inefficiency on the part of DAA and their failure to meet its own service standards.

There are a number of specific comments within the BAH report on which we would like to comment:

- On page 14 it is stated that if passenger numbers grow and real opex remains constant that service quality must decline. We do not accept the truth of this statement. It would be true if DAA had no scope for productivity improvement. As other parts of CAR's report show, DAA has substantial scope for such improvement. Consequently, it does not follow that service quality will necessarily fall in these circumstances. We believe BAH are paying insufficient regard to the scope for DAA to become more efficient.

- At a number of points in the report BAH refer to the lack of formal service quality agreement. As stated above, Aer Lingus agrees that the lack of these formal agreements is a serious issue which needs to be addressed as a priority. We do not agree, as suggested on page 74, that it may be adequate merely to quantify and publish statistics on certain aspects of service quality. If DAA does not operate under binding service level agreements with effective penalties for failing to deliver, then there is no guarantee that DAA will provide an adequate level of service to airlines.

- On page 69 it is suggested that airlines should manage passenger flows and congestion with "enforceable service level agreements". We find this comment ironic given the lack of formal service level agreements on DAA. Airlines are not in a position to manage passenger flows and congestion within the terminal building. Such congestion is almost entirely a function of the design and layout of the terminals) based on current and past decisions by the airport operator) and DAA's provision of security screening staff and equipment to meet new and enhanced security standards.

- The analysis of DAA's costs from page 84 casts little light on the composition of DAA's costs and how these compare with an efficient level. Most costs are assumed to grow with an elasticity of 35% with respect to passenger numbers. This is a familiar figure. Similar values have been used in past price-setting exercises both for Aer Rianta and for BAA. However, given the trend towards using larger aircraft and the fact that the growth in the number of movements is significantly slower than the growth in the number of passengers, we feel that proper consideration should be give to whether this parameter is correct going forward. In particular, whether it should be adjusted downwards.
- We note that the graphs on page 90 indicate a significant real increase in costs in 2003 and 2004. We are concerned that BAH do not properly analyse the reasons behind this increase, whether it is justified and whether it should be allowed in the initial cost base for price setting. This is relevant in the context of the TRL and ATRS reports, which both indicate that Dublin Airport is significantly less efficient than its most efficient comparators.
- It is assumed that payroll costs should be allowed to grow at 3 to 3.5% over the rate of inflation. This assumption is contrary to regulatory precedent, under which it is usually assumed that increases in real wages must be accommodated from improved efficiency. For instance, the UK Competition Commission, when reporting on BAA in 2002 wrote at para 2.350: "We have no objection to such an assumption of real pay increases as long as it is financed by real productivity increases". We believe that the increase in real wages, applied to the 60% of DAA's costs that are accounted for by payroll, is one of the reasons that CAR's Draft Determination presents a far to lenient target for DAA's opex efficiency.
- The conclusion to the report is an inadequate efficiency benchmark set by itself and a feeble increase by BAH. 4.9% over 5 years. Less than 1% in real terms. Would expect nearer to 2% national average.

(b) Annex 11: TRL & ATRS Results

Although a range of results are reported in this annex, we note that the general conclusion is that Dublin Airport is an average or slightly below average performer amongst its peers in terms of costs and productivity.

We note that typical result shown in this annex rank Dublin's costs per passenger at 5.77 "SDRs" relative to the efficiency frontier of 4.04 in 2002, suggesting that Dublin's efficiency is about 70% of the best that can currently be expected. ATRS' estimate of variable factor productivity puts Dublin airport at 61% efficient.

In our view it is CAR's duty to take steps to push Dublin Airport towards the efficiency frontier for airports in its class within the shortest feasible timescale. We note that the conclusion of this annex that Dublin Airport has significant scope to improve its efficiency. Hence we are disappointed that the Draft Determination is not specific about the size of the efficiency improvement being expected of DAA over the next regulatory period.

(c) Conclusions

Aer Lingus considers that DAA has significant scope to improve its efficiency, and that CAR's Draft Determination presents DAA with an insufficiently challenging target for the next regulatory period. As such the Draft Determination does not meet CAR's obligation to facilitate the efficient and economic development and operation of Dublin Airport, because it would allow DAA to continue to operate inefficiently.

In our view an appropriate target for operating efficiency would start with the 2004 opex identified by BAH and would project this forward allowing:

- a cost elasticity relative to passenger growth of no more than 35%;
- an annual efficiency target reflecting the general economy-wide improvement in productivity. In our view this should be a least 1%p.a. By way of example, the UK water regulator Ofwat, found that the scope for general annual efficiency improvement was 0.6% p.a.. This is in a sector that is much more capital intensive, slow moving with less opportunity to improve operating efficiency than is the case in airport operation;
- an annual catch-up factor intended to make DAA move towards the efficiency frontier. The evidence presented by CAR suggests that Dublin Airport may be conservatively assessed to be 30% from the efficiency frontier. Recognising that cost improvements cannot be achieved instantaneously, and in line with other regulatory precedent, we consider it would be appropriate to set a catch up factor that could be expected to move DAA halfway to the efficiency frontier by the end of the next regulatory period. This would be a reduction in real terms of 15%, spread over six years from 2004, amounting to approximately 2.5% p.a.;
- furthermore, in line with other regulatory precedent, DAA should be expected to absorb real increases in wages in productivity gains. There should therefore be no additional allowance for increases in real wages.

We are concerned that that CAR's opex targets for DAA are insufficiently challenging to meet the objective of making DAA cost competitive.

In addition to the more challenging targets which we set out above, Aer Lingus believes there are further steps that can be taken to ensure DAA improves its operational efficiency as rapidly as possible. First the operation of all new facilities can be competitively tendered. This does not preclude DAA from ultimately choosing to operate facilities itself, but would ensure that it could only do so at a competitive price for the airlines. Secondly the evidence gleaned from this competitive process could be used to benchmark costs in T1 and ensure that DAA is providing value for money there as well.

Finally, we consider that CAR should introduce some "carrot" as well as "stick" into the regulatory mechanism, so that if DAA does outperform its opex targets (and delivers on the agreed level of service) it can retain the benefit of this out performance or a period of (say) five years, by being granted an out-performance allowance in addition to its base opex and the next Determination.