DAA Comments on Responses To Commission Paper CP7/2004:

Consultation Paper on the making of a New Determination under the Aviation Regulation Act, 2001, as amended by the State Airports Act, 2004

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ÚDARÁS AERFORT BHAILE ÁTHA CLIATH cpt

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1 Introduction

We welcome the opportunity afforded by the Commission for Aviation Regulation to comment on submissions made by airport users and interested parties following the publication of the Commission's consultation document CP7/2004. While we agree with the broad thrust of the analysis put forward by the majority of the submissions, the company also wishes to respond to a number of specific comments made.

2 Objectives in Section 33 as substituted by the 2004 Act

Means of Attaining Statutory Objectives

We agree with the general consensus that the Commission should set about attaining its statutory objectives by aiming to maximise economic efficiency. In the company's view, the best way to achieve this is to ensure the financial stability of the Dublin Airport Authority as this is vital to "facilitate the efficient and economic development and operation of Dublin Airport which meets the requirements of current and prospective users" and is also required in order to protect the "reasonable interests" of those users. As noted in the report submitted by Dublin Airport Authority in response to the DotEcon paper, and prepared for it by NERA, both productive and dynamic efficiency could be adversely affected by an approach to regulation that threatens either to reduce the profits of the regulated company below normal profit or, more seriously, to increase the risk of bankruptcy. Ensuring financial viability is therefore a key concern if the Determination is to allow productive and dynamic efficiency to be achieved and maintained. This in turn enables the statutory objectives to be attained and economic efficiency maximised.

In its submission, Aer Lingus suggests that the term "economic and efficient" should be interpreted as "cost effective". We consider this to be an extremely narrow definition that does not appear to be consistent with the intent of the revised legislation (in which the words "cost effective" have been replaced by "economic and efficient"). The Aer Lingus interpretation also fails to consider the requirements for the economic development of Dublin Airport into the future.

Definition of Users

We note that a number of respondents appear to have adopted a common but narrow interpretation of the term airport user and have defined the interests of users as being synonymous with that of airlines. This is not consistent with the clear and intentional change in the legislation to widen the definition of users - the explanatory note to the Bill states that: *"a definition of 'user' for the purpose of determining airport charges is also included for the first time."* The new definition as set out in Section 22 of the State Airports Act, 2004, would include for example, passenger and cargo airlines, the general public, control authorities, government agencies, industry representatives etc.

Some respondents have implied that as the airlines are the users paying airport charges, they should be treated more favourably than other users. Such an interpretation has no objective basis and appears contrary to the specific provisions of the Act, which includes a clear definition of ''user'' for the particular purpose of determining airport charges. To ascribe a greater significance to one particular category of user to the exclusion of others is simply not justified by the clear intent of the legislation.

Furthermore, it is misleading to suggest that it is only airlines that pay airport charges and pay for investment at airports - ultimately it is the consumer that pays. At most airports, aeronautical charges do not cover aeronautical costs. This has led airports to subsidise aeronautical charges with commercial revenues that airports have taken the initiative to develop. Dublin is no exception to this trend as commercial revenues serve to subsidise airport charges through the single till. These commercial revenues are earned from a variety of sources including direct sales to consumers. Finally, it is also notable that almost all airlines pass through passenger charges to the traveller as part of the cost of the ticket and in many cases, airlines present airport charges to the general public as a directly passed through cost to the passenger.

Interpretation of Users Needs

We disagree with the view expressed by the Competition Authority that airline interests automatically coincide with passenger interests. Airlines' business objectives may not necessarily result in the best outcomes for passengers. For example, as noted in our response to CP7/2004, existing users might not favour capital expenditure to facilitate capacity increases at the airport, as this would enable market entry by other carriers, a development that, though positive in terms of providing a wider range of choice for passengers, might damage an existing users relative position.

Prioritising investment in terms of airline needs could also lead to conflicts of interest. For example, airlines that provide retailing and catering on board their aircraft might oppose investment in the development of such facilities at the airport, despite the fact that other users might require the services.

We are of the view that, given the wide definition of airport user set out in legislation, it is appropriate to actively seek to establish and address the interests of the range of users utilising Dublin Airport as well as seeking to understand and incorporate the requirements of airline users. Such an approach is also more likely to result in a better appreciation of both short term and longer term needs, an objective that has been espoused at international level by Airports Council International, which notes that:

> *"It is important that (capital expenditure) decisions made now are balanced and reasonable, not only for today's consumers but because the consequences of such decisions will ultimately be a legacy to the consumers of the future."*[1]

In this regard, the company plans to canvass the views of a broad range of users on facilities, service quality etc. over coming weeks and would welcome an opportunity to open a dialogue with the Commission to understand how the outcomes of such a process might be incorporated in its decision.

[1] A Logical Approach to Airport Charges, ACI Europe, June 2004

3 Statutory Factors

3.1 The Restructuring

Aer Lingus suggests that "costs presently in Dublin that relate to the coordination of the three airports" be excluded from the determination for Dublin. We agree that costs relating to the provision of shared services (elements of which are located at each of the airports) which are charged or appropriately allocated to Cork and Shannon airports should be excluded from the determination for Dublin Airport[2]. This does not provide, however, a basis to ignore or exclude other costs incurred by the Dublin Airport Authority (for example, annual reports, audits, marketing, etc.) that will not be avoided by the break up and it is appropriate that these be allowed in the Determination for Dublin Airport[3].

Where Dublin Airport Authority is responsible for costs or liabilities arising, inter alia, from the restructuring and reallocation of Aer Rianta's assets and liabilities, the State Airports Act, 2004 requires that these costs and liabilities be given due regard in setting the next regulatory determination for Dublin Airport. Their inclusion in the next determination is essential if the Commission is to attain its statutory objective to enable the Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner.

3.2 The level of investment

A number of submissions have referred to a requirement that capital investment be "agreed with airlines". We consider consultation with airlines on the capital programme to be important in order to:

- ensure that airline requirements are fully understood
- assist in the process of defining an appropriate level of capital expenditure over the medium term
- enable the costs and benefits both of the overall strategy and of individual projects to be adequately evaluated

However, given the diverse interests and business models of airlines, full agreement on the investment programme is not necessarily feasible. Furthermore, given the Commission's statutory objective to meet the needs of a broadly defined set of current and future users, granting existing airlines an effective veto on future capital expenditure could result in investment required to meet other current and future user needs being sidelined.

To facilitate effective consultation all parties must engage in a constructive manner. If the airport authority presents a rational and well founded basis for its investment proposals these

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[2] Or recognised as income of Dublin Airport Authority from any arrangements entered into by it for the purposes of the restructuring under the State Airports Act 2004

3 This also facilitates the company's duty under Part III, Section 4 of the Air Navigation and Transport (Amendment) Act to ensure revenues are not less than sufficient to meet all properly incurred costs.

should not be set aside on the basis of unsupported comments by airlines or any other users. We concur with the UK Civil Aviation Authority's view that:

> *"Where the airlines are in disagreement with the airport operators or amongst themselves, they should provide systematic and detailed evidence to support any criticisms they make, explaining why current practice or proposed solutions are inefficient, or how their views have not been adequately taken into account"*[4]

In this context, Ryanair's assertion in its submission that the proposed runway at Dublin is "entirely unnecessary and over-specified", is unsupported and without foundation. In June 2001 National Air Traffic Services Limited (NATS) was commissioned by the company to undertake a study to review the airside capacity at Dublin Airport. The study was carried out over a number of months and included various workshops in which the airlines (including Ryanair), the IAA and the company participated. Work was completed in September 2002. The substantive conclusions of the study found that the construction of a new parallel runway is preferable to extending the existing runway 11-29[5] because it:

- Has a lower capital cost
- Is more cost efficient per movement delivered
- Is compatible with the County Plan
- Is more deliverable
- Has less impact on existing infrastructure

Due to the relative volumes of passengers and cargo at Dublin[6], the needs of passengers were given some prominence in the master planning exercise, however the needs of cargo operators were also taken into account. The IAIEC criticises the masterplanning the approach to planning for cargo developments as part of the process undertaken at Dublin. We continue to hold the view that the masterplan is the starting point for defining user requirements. Several meetings were held with the cargo community to assess their requirements going forward and cargo operators were also invited to all stakeholder meetings. Ultimately, the masterplan ensures that an appropriate allocation of land is made to allow for the future growth and development of the cargo sector at Dublin. We plan to consult further with the cargo community in the future to assess its precise requirements regarding the way in which this land bank is developed to meet its needs.

3.3 A reasonable rate of return on capital

The fact that a number of respondents acknowledge the airport operator's entitlement to earn a reasonable return on capital in the context of its omission as an explicit statutory factor in the State Airports Act, 2004 supports our view that this is implicit in the Commission's new statutory objective to enable the Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner. The regulated entity must be permitted to earn an appropriate return on its investment in order to comply with the statutory objective.

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[4] Airport Regulation: Looking to the future, learning from the past; UK Civil Aviation Authority, May 2004, pg x

[5] An option favoured by Ryanair

[6] The ratio for passenger work load units versus cargo work load units in 2003 was approximately 12:1

We strongly agree with Aer Lingus that "*the appropriate ex ante target rate of return for a regulated company is its weighted average cost of capital*" and that the Commission has a statutory duty to determine airport charges that provide the Dublin Airport Authority with a return on its investment equal to its weighted average cost of capital in order to ensure the financial viability of the Authority. It is appropriate for the Commission to determine the maximum level of airport charges so that the company is permitted to earn its weighted average cost of capital over the course of the regulatory period. We also accept that, due to the smoothing effect generally involved in setting the regulatory price cap, the company's return may not be equivalent to its weighted average cost of capital in each year. However, it is not clear to us how Aer Lingus envisages that permitting a return equivalent to the weighted average cost of capital year on year will undermine the company's incentives to achieve and maintain productive and dynamic efficiency.

Aer Lingus has suggested that there would be no justification for allowing the servicing of costs for an inefficient capital structure. As noted in the response to DotEcon, we are of the view that to disallow such costs would result in airport charges being set below actual costs which would have a negative impact on allocative efficiency potentially leading to a reduction in overall economic efficiency. Furthermore, it is possible that apparent "inefficiency" in the Authority's financial structure (i.e. high gearing) could be outweighed by positive contributions to economic efficiency elsewhere (e.g. allowing the anticipated benefits from separating the three airports to be realised earlier than would otherwise be possible). To disregard the former therefore could have a negative rather than positive impact on overall economic efficiency.

Aer Lingus also suggests that the assumption that prices are set to reflect an efficient capital structure for a regulated enterprise is an assumption applied by regulators in the UK and elsewhere. This does not appear to be consistent with regulatory precedent, as airports' actual gearing levels have been used as the basis for estimating the cost of capital at a number of price reviews[7]. It is also worth noting that the Commission's consultants DotEcon acknowledge that there is no accepted model for identifying a firm's optimal financial structure and that in its absence the firm's actual gearing is generally used.

3.4 Level of income

We note the broad support among airport users for the retention of the single till. While the company has conditionally accepted a continuation of the single till approach for the forthcoming determination[8], it does not accept the Aer Lingus view that the single till principle should be retained as a matter of economic efficiency. It is widely recognised that the application of the single till may weaken economic efficiency in the case of congested airports and in these circumstances the dual till mechanism offers superior economic incentives. We note that the Commission concurs with this:

[7] See regulatory decisions made by the CAA, the UK Competition Commission and the Commission for Aviation Regulation

[8] In forecasting the non-aeronautical contribution to the single till, realistic assumptions reflective of the risks inherent in commercial activities should be used in projecting future revenues and costs. Where achieving assumed future non-aeronautical revenues are contingent on provision of additional infrastructure, the latter must be permitted as recoverable capital expenditure. The principle whereby revenues with insufficient nexus to the regulated activities are excluded from the regulatory till should continue to apply (i.e. ARI, the Great Southern Hotel Group and the company's joint venture properties should remain excluded from the Dublin Airport single till).

"… the Commission continues to hold the view that there may be potentially adverse incentive effects of a regulatory till including commercial revenue on operations at airports approaching the limits of physical capacity." [9]

3.5 Costs or liabilities

Aer Lingus has expressed its concern that debts incurred for the development of Cork and Shannon airport may be transferred to Dublin resulting in price increases in order to finance the debt. Until the form of restructuring has been determined it is unclear how the debts relating to Cork and Shannon will be treated. However, if, as part of the restructuring, a decision is taken to transfer debts incurred for the development of Cork or Shannon airports to Dublin Airport then the State Airports Act, 2004 explicitly requires the Commission to have due regard to these costs and liabilities in setting the regulatory determination specifying the maximum levels of airport charges that may be levied by the Dublin Airport Authority in respect of Dublin Airport.

Having regard to such costs or liabilities is important if the statutory objective to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner is to be met. This could be accomplished either through treatment of these financial obligations as additional assets in the Dublin Airport RAB or as an additional allowance to cover the liabilities arising from any adopted debt.

3.6 Policy Statements

We broadly agree with the respondents' views in relation to this statutory factor.

3.7 Cost Competitiveness

We note that Aer Lingus supports the approach that the Commission has taken to benchmarking and that the airline considers that no change in approach is required. However, the reference to operational efficiency, which was previously contained in this statutory factor, has been deleted. This provides support for the company's view that the emphasis previously placed on operational efficiency is of lesser significance than cost competitiveness. The deletion of the reference to *operational efficiency of airport services at the airport with respect to international practice* weakens the rationale for any approach which places reliance on comparative benchmarking. We would like to emphasise that if the Commission is to continue applying this approach, it must ensure that any comparative benchmarking used in order the assess the relative cost competitiveness of Dublin Airport should take account of any significant comparability issues at other airports or in other jurisdictions when generating results.

It is interesting to note that Ryanair appears to suggest in its submission that the conclusion by the Commission's consultants IMG that the former Aer Rianta was 50% more inefficient than the best of its peers, (a conclusion which was not in fact reached in the IMG report), should be directly reflected in a decrease in airport charges. Ryanair have failed to acknowledge that the Commission did include challenging operating expenditure efficiency targets in its price cap Determination.

[9] Commission Paper CP8/2001

Aer Lingus expressed the view that there is “still substantial inefficiency at Dublin Airport”. This comment is unsubstantiated and rejected by the Dublin Airport Authority. In CP6/2004 the Commission highlights the fact that it has a statutory obligation to give reasons for its determination. In this context, unsupported comments from any party are unhelpful to the process of making a determination and should be ignored.

3.8 The level and quality of services

Respondents have not commented to any significant extent on the level of service quality that they require at the airport. This is an important issue, as any conclusions on service quality must be related to operating cost, capital expenditure and passenger throughput. For example, the majority of airlines at Dublin request that they be allowed to operate from contact stands.[10] A high level of investment in stands and piers will be required if this level of service is to be maintained in the future.

We understand that the Commission intends to undertake consultation in relation to service quality and required standards as part of its capacity assessment workstream. The company welcomes this development and looks forward to active participation from all parties in addressing this important issue.

3.9 Minimum restrictions

We note bmi’s comments regarding the sub-cap for off-peak use of the runway. This supports the Authority’s contention that the implementation of this price cap is incompatible with the requirement to place the minimum restrictions on the company and therefore should be discarded in the next Determination. We take this opportunity to reiterate the findings of the Aviation Appeal Panel, which noted that: *“the sole use of ACN as the basis for setting landing charges appears to be unique and thus not consistent with practices at other airports”*.[11]

[10] 94% of departing aircraft and 97% of departing passengers were handled at contact stands in 2003
[11] Aviation Appeal Panel Decision, January 2002, page 13