CP1/2007 Public Consultation on DUB airport charges following the capital investment programme 2006

Response by bmi dated 9 March 2007

bmi welcome the opportunity to comment on the CAR's consultation paper CP1/2007 regarding proposed investments and resultant airport charges at Dublin Airport.

Airlines operate in an intensely competitive market and the viability of airline services at Dublin, particularly domestic and short-haul services, depend on a regulatory framework and price control that delivers minimal and economically viable pricing consistent with cost effective services and facilities provision in line with airline requirements, and importantly this must be delivered on a level playing field.

These aims fit perfectly with the CAR's objectives as stated in Section 33 2001 Act;

- to develop the airport in a sustainable and financially viable manner
- to facilitate the efficient and economic development and operation of Dublin Airport which meets the requirements of current and prospective users
- to protect the reasonable interests of current and prospective users in relation to Dublin Airport

The investments proposed by DAA and the issues for airport charges discussed in the consultation paper should therefore be assessed in the first instance to ensure the proposals meet the CAR's objectives.

The key fundamental issues arising from our review of proposed investments and impact on airport charges as presented in the consultation paper, are as follows;

1) DAA propose to build T2 to a higher level of facilities and service provision than pertains in T1, and above IATA level C service standard.

   This will introduce a fundamental disparity in competitor equivalence that must be recognised and addressed within the price control framework. bmi and other T1 users will be placed at a commercial disadvantage, and we shall expect differential charging to apply for so long as the disparity exists.

2) The forecast cost of T2 has increased from €234m in May 2005 to €607m, and the level of cost is now 74% above the average benchmarked as part of this review.

No road map or explanation of the increase in costs to the current level has been provided, and there is no explanation or reconciliation of the excess cost proposed compared to the benchmark.

3) No interim solution has been agreed with DAA to ensure viable operations on a level playing field for users while construction works are underway. This is a key issue to be resolved as part of, and in advance of, agreeing to proceed with the T2 project. Eg) availability and allocation of stands, and any fee rebates to offset the costs of additional bussing and commercial disadvantage.

4) Consequently, the proposed cost of T2 appears to be excessive and the costs have not been substantiated. As investment costs are a significant driver of airport fees and it is essential that the costs are reasonable and in line with benchmark cost, we cannot support the investment as proposed.

5) Further, we are concerned that Pier C developments are soon to be redundant to make way for T2 works. Clearly the sunk costs of this project have to be considered within the total cost of the T2 project proposals, but this raises the question of effective and efficient, value for money planning proposals, and unnecessary costs borne by users.

Our comments in response to the specific questions raised by the CAR are set out below.

Q1. Does the DAA's investment plan represent an improvement on earlier plans? Are the changes in costs justified?

A justification of the increase in T2 costs from May05CIP to the latest projection is essential. The only breakdown available is for the project as a whole. A 158% increase on the May05 CIP suggests specification changes based on improving the quality of service provided. What are these improvements, and why are they costing so much (especially in comparison to the benchmarked UK airports)? There is a suggestion that this is due to the inclusion of a pier E in the latest CIP which wasn't in the original – it would be useful if this analysis could be produced.

Q2. What are the advantages & disadvantages of using trigger-pricing principles when setting price caps for airport charges at Dublin airport?

The primary advantage of trigger pricing is that it provides an essential link between price and output delivery, that is otherwise missing within the regulatory framework. It also allows the carriers to see progress being made

in accordance with preset deadlines and objectively rewards the DAA for timely completion.
Other than those mentioned in CP1/2007, one potential disadvantage of trigger-pricing is that construction projects commonly fall behind schedule. If T2 does start to lag behind, there will be pressure to reach that trigger point by dispensing with quality. Trigger-pricing could lead to cutting corners immediately prior to the trigger point. It is therefore critical that triggers are readily measurable to avoid such practice.

Q3. For what projects in CIP2006, if any, should the CAR incorporate the principle of trigger pricing when making future determinations? To what key milestones & dates should the triggers relate?
The trigger point should relate to completion of defined major milestones – these should be objectively defined in advance so that achievement can be readily measured and appropriately signed off by the key stakeholders.
bmi would recommend a number of trigger points for major investments spread over the life of the project.

Q4. Are there any reasons for allowing the DAA to start levying higher charges to allow it to fund CIP2006 in advance of the projects being completed?

No. There are very few industries where you go to the customer in advance and ask for an increase in price for a service that will only benefit future customers. Pre-funding adds unnecessary cost to existing airline operations and their passengers. This is an internal matter for the DAA and could be resolved through 3rd party financial channels.

Q5. Should charges to recover the costs of CIP2006 be front or back loaded?

It would be preferable for charges to be back-loaded from the point of view that revenues would then match with costs for the carriers (as more passengers would be using the airport in the later years of the project's life). As the DAA would be decision-neutral (as NPV for both options is the same), back loading would give a benefit to the carriers whilst not impacting on NPV for the DAA.

Q6.What traffic forecast should be used when setting the price cap? Who should bear the risks if demand out-turns does not correspond to the initial traffic forecast?

The CAR should commission an independent forecast to validate the justification for T2 expansion. In the Commission paper (CP1/2007) it shies away from this for fear of the forecasts being materially different. However bmi would like to know if these forecasts are materially different and why., especially as the forecasts are a key driver of price to airlines. .
It is important that realistic forecasts are used for this process and the CAR should not rely on forecasts produced by DAA that have not been

independently validated. It is in DAA's interests to provide conservative forecasts as this may lead to a higher price cap determination.

The question of sharing risk should be geared more towards how to reduce it (to all parties) by ensuring a cost-effective T2 build, rather than who should share the burden in the event that the terminal doesn't have the throughput of passengers the DAA currently estimates.

The carriers already bear the risks of under-performing routes, inefficient use of aircraft etc. The under-utilisation of an airport terminal is a risk belonging to the DAA and it should look to minimise this risk rather than look to share it amongst its customers.

Q7. What actions, if any, should the CAR take to strengthen regulatory commitment and credibility with respect to the level of charges it will allow in future determinations for the funding of the CIP2006? Should the length of the price cap be increased?
bmi feels that there are 2 main courses of action the CAR may wish to consider to strengthen it's commitment & credibility:

- <u>Strengthening of benchmarking process</u>
  The benchmarking process indicates that the cost of T2 is very high. DAA benchmarking revealed T2 & pier E should cost in the region of €3,500 per square metre. The DAA has submitted a square metre cost of around €8,000. This is indicative of both the service level being much higher than anything offered in the UK and the inclusion of excessive & unnecessary costs.

  Moreover the DAA has used a sample with around 50% of BAA airports. We are concerned that BAA have been used in the benchmarking exercise as BAA has extensive monopoly power which has resulted in less than maximum cost efficiency being proven. Three independent consultants were commissioned by airlines at Heathrow to review capital cost efficiency - each suggested there was work to be done to minimise costs (ref WTP report dated September 2003, Avia Solutions report dated January 2004, and Currie & Brown report dated February 2006), and BAA have reduced cost estimates to date with more work promised going forward.
  BAA airport terminal builds are relatively more expensive than the average terminal build. Further, the 3 London BAA airports have been included for which a London premium may also pertain.

  The benchmark process would have a more reasonable basis if more non-BAA airports could be sampled as the Scottish & London BAA airports are effectively non-competitive (unlike Dublin which is in direct competition with the Belfast airports).

  Given these comments, we may expect a highly competitive benchmark cost to be lower than the €350m derived from this analysis, which suggests that the cost of T2 is even more excessive than shown by this analysis.

The CAR have suggested there may be a flaw in the benchmarking process thus invalidating what is a useful and objective process. If it is flawed, explanations as to why it is so need to be provided.

The alternative conclusion that the costs are due solely to service level increases has not been substantiated as the breakdown of T2 capital spend has not been provided.

To conclude, any differences from the benchmark need to be fully investigated as matter of urgent concern.

- <u>CAR commissioned independent passenger forecast</u>

  As per Q6.

The length of the price cap should not be increased, as a 5 year term is a reasonable timeframe for the various assumptions and bases. A longer timeframe is subject to even more estimation and industry change not readily accommodated within a price cap.

Q8. Should Terminal 2 be built to satisfy a busy-hour capacity of 4,200 and provide a level of service equating to IATA level C?

Yes. IATA level C is the level in T1 – T2 should be the same.

The IATA manual (sub section 9.1.2 Level of Service) states that level C 'denotes good service at reasonable cost'. The implication is that anything above this would improve the service but at a cost.

Q9. Is €609million a reasonable estimate of the cost to build the proposed new terminal & pier?

See reply to Q13.

Q10. Is it appropriate to use benchmarks?

Yes, benchmarking is a means of providing independent validation to a project that can assuage the stakeholders' concerns.

Q11. What are the merits of using peak load pricing for airport charges at Dublin airport to fund terminal 2?

Peak period pricing penalises business customers of the airport. IATA studies over the years have repeatedly shown that peak load pricing has minimal impact on the behaviour of scheduled passengers who will invariably want to travel early morning and return in the evening. So it is a charging method rather than a mechanism seeking to change the daily profile of demand. The main impact of peak period pricing is:

- It will make the cost of operating peak-time business schedules for all carriers from DUB significantly more expensive when competing with other airports & other modes of transport. The fare paying passenger will only accept a certain level of fare increase (passed on by the carriers) before looking elsewhere for alternatives.
- It effectively discriminates against the EU business passenger.

Q12. What calculations should the CAR make if it decides to set a price cap that encourages the DAA to recover the costs of expanding Dublin airport by means of peak load pricing?

See Q11.

Q13. How much would users be willing to pay in airport charges for the improved quality experience that they expect T2 to provide?

Given that the biggest single improvement derived from T2 is the increased capacity, the quality improvement over and above this will enhance the passenger experience, and will introduce a commercial benefit for T2 users over T1 users. As noted previously, the commercial benefit should be paid for by T2 users, and differential pricing should apply accordingly to at least partially compensate T1 users who are placed at a commercial disadvantage. It should be recognised that T1 users directly compete with T2 users operating the same routes. Both terminals will provide service standards at IATA level C, so any additional cost should be minimised. €607m appears excessive (compared to the benchmarked €350m and the May05 CIP estimate of £234.8m). Even allowing for flaws in the benchmarking process, 74% more cost over the benchmarked airports suggests inefficiencies or excessive costs that don't bring equivalent tangible benefits. We are looking to the CAR to clarify exactly where the increase has come from, providing a roadmap from May05 CIP to the latest estimate.

In addition to this, projects such as terminal builds often go over budget due to missing deadlines, spec changes etc. So it is not inconceivable that we could be debating another large increase 6 months from now, on top of the current estimate.

Q14. What are the merits of using differential pricing when setting airport charges for T1 & T2 users at Dublin airport?

Differential pricing would pass the cost of the service upgrades at the new terminal onto those carriers that are directly using & benefiting from these upgrades in service. In terms of the user pays principle, championed by the CAR, this is the most equitable & impartial method of charging for all carriers.

Differential pricing applies at Glasgow airport for the use of the east pier, which is deemed to offer lower cost facilities. By way of example the application of the differential pricing principle is being used by bmi at LHR with the build of T5.

As bmi competes with other airlines at Dublin on the same route (LHR-DUB) it is in everyone's interests that a level playing field exists upon which this competition can thrive. The increased service level of T2 removes this level playing field as it will offer a better service to those carriers using it. Differential pricing would re-establish this level playing field.

As a corollary of the differential pricing mechanism, there needs to be a scheme to capture the 'higher standard of service' over and above that of IATA level C so as to ensure that all costs attributable to the higher standard of service are charged under differential pricing (and don't end up falling into peak period pricing). This needs to be a transparent document available to all the airport's users.

Q15. What calculations should the CAR make if it decides to set a price cap that encourages the DAA to recover the costs of improving service qualities in T2 by means of differential pricing?

CAR should ensure that the costs being recouped by differential pricing are those costs directly attributable to the improvement of the terminal over and above IATA service standard C.

Summary

Such a project is not without risk. The current cost proposals suggest inefficiencies against the benchmarked airports of the UK which would increase the risk to all parties. Both the DAA and its customers are required to make returns on capital and in this respect the proposed cost of T2 makes it more difficult for all concerned to achieve a reasonable return.

Consequently, the proposed cost of T2 appears to be excessive and the costs have not been substantiated. As investment costs are a significant driver of airport fees and it is essential that the costs are reasonable and in line with benchmark cost, we cannot support the investment as proposed.

An interim solution must be agreed with DAA to ensure viable operations on a level playing field for users while construction works are underway.
In order to ensure that T2 is economically viable and that it meets the users' requirements it is recommended that:

- T2 costs should be scaled back to that of IATA service level C.
- Only the reasonable benchmarked cost of T2 should be included.

- Recovery of costs (up to IATA service standard level C) through the normal tariff structure (rather than peak period pricing) would be the most equitable way of recouping T2 project costs.
- In the event that the service standard of T2 goes above IATA level C, any cost associated with this should be recouped under differential pricing. CP1/2007 provided €259million as an estimate.
- Peak period pricing would penalise Dublin's business customers and hence would not be an equitable way of cost recovery.