



**Discussion Paper**  
**Guidance on the approach to capex consultation**

**Commission Paper 8/2007**

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## **1. INTRODUCTION**

The purpose of this discussion paper is to provide guidance on how Dublin Airport Authority (the DAA) and the Irish Aviation Authority (the IAA) might consult with users in advance of carrying out investment projects. The Commission for Aviation Regulation (the Commission) previously signalled its intention to publish such a paper at the time of the Determination for aviation terminal service charges (ATSC, CP4/2007) in March 2007 and during the Interim Review of airport charges at Dublin Airport (CP6/2007).

The Commission is keen to foster a regulatory environment that encourages the DAA and IAA to develop efficient capital expenditure (capex) programmes. Consulting with users prior to investing should help ensure that a capex programme delivers services that users value sufficiently, thus helping to realise allocative efficiency.

It is intended that the guidelines presented here would apply to all proposed investments by the DAA and the IAA relating to services captured by the price caps: planned investments included in Capital Investment Plans (CIPs) in advance of each multi-year price control and actual investments not included in such CIPs. To determine what costs to include in the regulatory asset base (RAB) the Commission will seek evidence that suitable consultation took place when assessing planned capex and, ex post, actual investments not previously considered in the consultation preceding a multi-year price-cap.

The Commission considers that the better regulatory policy is to reach a situation where the regulatory debate centres on what potential there is for the regulated entities to realise efficiency savings, rather than assessing whether or not individual investment projects are warranted. Users are best placed to know what facilities they want the DAA and the IAA to provide. Unfortunately, this year the Commission received only limited evidence of airline acceptance of the capex plans submitted during both the interim review of the DAA's price cap and the determination relating to the IAA's ATSC. As a consequence, the Commission had to spend considerable resources considering whether investments were justified.

This paper provides guidelines, rather than absolute requirements. The Commission recognises that the nature of consultation between the regulated companies and the airlines may evolve over time as the requirements of the various parties and the business environment in which they operate change.

The remainder of this discussion paper is outlined as follows:

- Section 2 summarises the background to the development of the capex guidelines;
- Section 3 sets out the capex guidelines and discusses how the consultation process might work for both *ex ante* and *ex post* capex reviews;
- Section 4 concludes

The paper includes an appendix summarising the UK experience in the aviation sector with constructive engagement at BAA's London airports.

## **2. THE RATIONALE FOR PROVIDING CAPEX GUIDELINES**

This section presents the background to and motivation for the proposed capex guidelines. It begins by explaining why consultation with users may be more important for regulated entities, such as the DAA and the IAA, than it would be if those firms were operating in a more competitive environment. It then summarises the Commission's current approach to and experience of setting capex allowances for the purposes of the price cap. Finally, it outlines the potential benefits to various parties from implementing a set of capex guidelines along the lines of those proposed here.

### **2.1 The Need for Consultation**

In a competitive market, purchasers can choose from the supplier that offers the combination of price and service that best meets the purchaser's needs. Consequently, suppliers that incur unnecessary costs investing in capital improvements that users do not want will be unable to recover such costs while suppliers that fail to invest in capital improvements that customers demand will lose customers.

In a less competitive market, this may not be the case. A supplier facing weak competitive constraints does not necessarily have to provide a given level of services at the lowest cost possible. The option of using an alternative supplier if the DAA or IAA do not provide a service at minimum cost is curtailed. Similarly, in cases where the DAA or IAA offer a single level of service, some users may find themselves paying for services that they do not actually want (even when those services are provided at minimum cost) or not being offered services they do want.

Because the competitive constraints on the DAA and IAA are less than in many other sectors of the economy, it is arguably more important that they consult with users to ascertain what investments would be in the interests of their users. The Commission believes that it is also appropriate that the DAA and IAA should demonstrate that they have sought to consult in good faith with their users when developing capex plans. A failure to provide details of investment plans and consult with prospective users, in advance of the projects, might be of less concern to users with the option of using rival providers. However, given that this competitive constraint is muted at Dublin Airport, both in the case of airport charges and in the provision of aviation

terminal services, it is important that the DAA and the IAA demonstrate that they develop their services in a manner that reflects the reasonable requirements of their users.

## **2.2 Experience of capex reviews**

The Commission has made two determinations of the DAA's regulated airport charges, in 2001 and 2005. There have been two determinations of the IAA's Aviation Terminal Service Charges, in 2002 and 2007. The current price caps for the DAA and IAA are in place until the end of 2009 and 2011 respectively.

The model of price-cap regulation adopted by the Commission sets a ceiling on airport charges and ATSCs such that the regulated company is allowed to recover anticipated future costs, including an expected rate of return on the RAB. This approach is often referred to as the building-blocks approach, as the total revenue requirement is set equal to the sum of several cost building blocks: operating costs (opex), the regulated rate of return on the RAB (calculated as the Weighted Average Cost of Capital or 'WACC') and a return of capital (the depreciation charge). The return on capital and the depreciation charge are often jointly referred to as the company's capital costs. The capital costs allowed for in the revenue requirement are calculated so as to remunerate efficient capital costs incurred by the regulated company.

The importance of providing the regulated companies with the right incentives to develop and deliver an efficient capital investment programme is highlighted by the fact that capital costs currently account for a significant, and growing, proportion of the regulated companies' revenue requirement. For example, in 2007, capital costs accounted for about 38% of the DAA's revenue requirement; this share is projected to grow to 46% by the end of 2009. For the IAA, capital costs accounted for 35% of the total revenue requirement in 2007, and are projected to grow to 44% of the total revenue requirement by the end of 2011 (the end of the IAA's current price control period).

In the recent IAA price-cap determination (March 2007) and the DAA Interim Review (July 2007), not all users had agreed with significant elements of the capex plans. In some instances, airlines claimed to have had no knowledge of the plans; in other

instances the dissatisfaction related to perception on the part of some airlines that the regulated companies had failed to provide sufficient information to engage in constructive consultation. Consequently, it has generally been the case that the Commission has had to conduct forensic examinations of the companies' capex plans, including drawing on expert opinion, in order to form a view on the appropriate level of allowed capex to include in the RAB.

The Commission believes that its primary role should be in determining *how* allowed costs are remunerated such that the DAA and IAA are incentivised to deliver services as efficiently as possible. In terms of establishing (user) support for a given investment, the Commission has therefore indicated to both the DAA and the IAA that at future determinations that they will need to demonstrate that any capex that has either taken place, or is planned, is either motivated by recognised safety or external factors or has the clear support of users – be that airlines, passengers, or both groups of users. Demonstrating user demand for an investment will most easily be done by providing evidence of a satisfactory consultation with users, in particular airlines.

### **2.3 Benefits from developing a set of capex guidelines**

A move away from the current regulatory approach to capex, where the Commission is frequently required to carry out a detailed review of the regulated companies capex plans, can potentially benefit all parties.

- The regulated companies can benefit from a reduced administrative burden during regulatory reviews. Capex plans presented within the framework of the capex guidelines and subsequently agreed with users could be adopted and remunerated through the price cap without the need for a detailed analysis of the plans by the regulator. Even when there is less than 100% agreement for a given capex plan, the fact that it has been discussed within the framework of an agreed set of capex guidelines should enable parties to narrow their differences, reducing both the range of issues that the Commission reviews in depth and the consequent information requests.
- Moreover, the regulated companies can potentially benefit from being able to develop and implement capex plans with greater confidence about the regulatory review process. The system is designed to be as predictable as

possible in terms of the main policy issues: where users have indicated support for a proposal, the regulated companies can have confidence that the regulator will – subject to adherence to statutory objectives - include an allowance for the investment in subsequent determinations. This greater transparency and predictability in the regulatory review process should ultimately lead to a lower cost of capital for the regulated companies.

- The airlines will benefit from the opportunity to influence capex plans so that investments best meet their needs. Moreover, there is more potential for investment plans to be developed and implemented outside of the price-cap cycle, and any reduction in the cost of capital because of greater certainty relating to the regulatory process will ultimately feed through into lower airport charges.
- In its role as the regulator, the Commission will also benefit from being able to focus its attention on achieving the main aim of good economic regulation: namely, to create incentives within the price-cap regime to ensure that prices are at an efficient level and that the regulated companies have incentives to deliver services as efficiently as possible. A less interventionist role in capex plans is desirable for a regulator, provided it can still satisfy its statutory objectives. This approach in the Commission’s view (in the case of the airport charges regulation) is also consistent with the State Airports Act (2004) requirement that the Commission “impos[e] the minimum restrictions on Dublin Airport Authority consistent with the functions of the Commission”.<sup>1</sup>
- Passengers ultimately benefit from all of these changes through lower prices and/or a better travelling experience.

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<sup>1</sup> State Airports Act, 2004, Part 3, Article (22), subsection 4.2(h).



### **3. THE CAPEX GUIDELINES**

This section sets out the Commission's proposed capex guidelines. It begins with a brief overview of the price control review process and indicates exactly how the Commission envisages the capex guidelines feeding into it. This is followed by a description of the types of issues that could be covered by the guidelines. An attempt to provide more specific guidance on how consultation on capex plans might work is then offered. Arguably, a willingness to consult in good faith can be more beneficial than any specific process. Given the large variation in types of projects that might be conceived, there are practical limits to the advice that the Commission can give. Nevertheless, in this section the Commission attempts to categorise different types of project drivers and provide guidance on some of the issues that might be discussed for capex motivated by each of these drivers. It then provides a worked example of how consultation might proceed for a specific project, the plans to build a new air traffic control tower.

#### **3.1 An overview of the price control review process**

At future price control decisions for both airport charges and ATSCs, the Commission envisages that the detailed capex assessment work that has previously, and necessarily, been carried out by the regulator could be significantly reduced by virtue of an agreed process of consultation between the regulated companies and airlines.

The Commission envisages the guidelines for capex engagement set out in this document could apply to investment plans submitted for consideration in advance of a price-control period (i.e. CIPs), as well as to investment that takes place within a price control period but which was not initially included in the CIP, i.e. *ex post* assessments of the RAB roll-forward. The output from negotiations on capex between the regulated companies and the airlines – namely, an agreement on investment requirements and capital costs – will feed directly into both the Commission's calculation of allowed capex (*ex ante* assessment of capex) and the calculation of the RAB roll forward (*ex post* assessment).

For reasons outlined previously, the Commission believes that there are incentives for all parties to actively participate in an open and substantive consultation on future capex requirements. Such consultation can aid price control review processes, reducing the extent to which parties have to rely on the Commission to adjudicate on whether a project is needed. Moreover, if parties can agree on the

need for and cost of an investment project during a price-control period, it can proceed immediately. This is because having agreed to the investment, the regulated company can be confident that the Commission will update the RAB accordingly at the time of the next price-cap review.

The Commission currently seeks justification for capex projects relating to their timing, scale and cost. At future price-cap reviews the Commission will expect the DAA and the IAA to provide the following information in support of either an *ex ante* investment plan or a proposal to roll capex into the RAB *ex post*:

- A description of the project, including a project plan that sets out the key stages of the project and any inter-relationship or dependencies with other projects. The project description might also include a full risk assessment, outlining the possible implications of the project for ongoing airport operations, and how it is proposed these will be managed by the regulated company.
- An explanation of why the project is required. This could include, but is not limited to: the project driver, a cost-benefit analysis, the business case/IRR for the project (from the perspective of the DAA/IAA) and supporting information such as the demand for the project from airlines and passengers.
- The project costs and a justification as to why proposed (or actual, in the case of *ex post* assessments) project costs represent the best value. This could include information on the source of cost estimates, e.g. tenders or benchmarks used, and an explanation of the criteria used to determine which option was likely to represent the least cost option for the project.
- Identification of alternative options considered and why the preferred option is better.
- A consideration of any alternative options for the delivery of project outputs, with relevant financial analysis in support of value for money arguments.
- Details on how the regulated company consulted with airlines and the specific nature and strength of support for a project from the airlines that will be expected to pay for the investment. The strongest form of commitment

might be a long-term contract to use the facility at an agreed price. Alternatively, a letter of understanding or agreement between the users and the regulated companies might suffice.

- A summary of any aspects of the investment plan that some or all airlines either have not had the opportunity to comment on or have expressed disagreement, and the regulated companies' rationale for proceeding without reaching agreement on these points with the airline(s).

This list is suggestive of the information that might be provided, rather than a definitive, exhaustive list. During consultations, the parties may identify some additional information that needs to be shared, or conversely agree that certain material is unnecessary. The Commission does not wish to preclude such developments.

Assuming that materials provided to the Commission accord with users' understanding of the project, the Commission expects there to be little need for it to conduct its own forensic investigation of the investment plans except in those instances where the regulated company and airlines have failed to reach agreement.

### **3.2 Information required as part of the capex guidelines**

Both the DAA and IAA already engage in discussions with airlines on the need for and cost of major investment projects, with mixed views on how satisfactory current arrangements are. Airlines have stated that for some investment projects they were given no opportunity to consult on the project; and for other projects where consultation did take place, airlines have stated that there was a failure on the part of the regulated companies to disclose key information that would allow them to fully evaluate a given investment project. This has made it difficult for the regulated companies and the airlines to come to an agreement on the future investment needed to deliver the services that airlines require.

The information that the Commission expects to receive from regulated companies at the time of price-cap decisions provides guidance as to what it expects the DAA and IAA to discuss with users during consultation. For such consultation to be productive there clearly needs to be an appropriate exchange of information. One hypothetical

test that might identify whether the information is adequate is whether it would suffice for a Board of Directors or Investment Committee to authorise a major project. The Commission will seek evidence showing that airlines have been informed of the cost implications of a given project in terms of the impact on charges and possible alternatives. This could take the form of a 'ready-reckoner' model which illustrates clearly the link between various capex costs (and the proposed treatment of these costs in terms of the remuneration mechanisms) and regulated charges. To the extent that projects might be expected to affect net operating costs, the information provided to airlines should reflect this fact. Should the DAA and IAA require it, the Commission could work with the regulated companies to develop such a ready-reckoner model to provide with airlines as part of the consultation process. Risks associated with capex plans will be an important part of the consultation process. The parties should clarify what the risks are with a given investment and how they should be allocated. For example, is the regulated company willing to bear the risk of demand not materialising or is the airlines' support for a given project sufficient that they will offer to make a binding financial commitment to pay for the facility?

All airlines will not always demand the same services, particularly in the case of services provided by the DAA. This may result in different airlines seeking different levels of capex. For example, an airline may wish to negotiate changes in facilities and services which only provide operational benefits and savings to that particular airline. These operating cost savings may offset any increase in airport capital costs arising from change in services provided, therefore being to the overall benefit of the airline. To the extent that the nature of the services provided and the associated additional capital costs are airline specific, the Commission does not believe that these capital costs should be included in the required revenue calculation for the airport-wide regulated charge. The Commission believes that the most efficient pricing option is for capital costs relating to airline-specific service outputs to be recovered through differential charges. Consultations between the regulated companies and airlines should be alert to the possibility that certain investments benefit specific users, and as such thought should be given to the following types of questions:

- Can the additional capex costs be clearly linked to a facility or service requested by a specific airline (or group of airlines), but not other airline(s)?

- Would the investment take place if the airline(s) had not requested it?
- Is the airline fully aware of the cost implications, in terms of differential charges, over the lifetime of the asset (or long-term contract)?
- Can the airline commit to remunerating the capital costs of the specific facility or service, possibly through signing up to a long-term contract with the service provider (DAA or IAA)?
- Assuming that the airline(s) requesting the facility or service benefit directly from the project, are there any indirect benefits to other airlines operating at the airport and to what extent can/should these indirect benefits be incorporated into the price for the direct or indirect use of the proposed facilities or services?

The Commission accepts that detailed information exchange between users and the regulated entity may sometimes be impractical. For example, there may be a materiality threshold below which the requirements to consult in detail with users does not apply.

For information regarded as commercially confidential, the Commission will seek reasonable proof that the confidentiality concerns are justified, and that as much of the information as possible was shared subject to preserving commercially sensitive material. For example, if cost data are sensitive the regulated company should nevertheless provide airlines with a breakdown of the cost category headings and the allocation rules applied, even where it cannot provide the individual values for these different cost items. As and when required, the regulated company could share the confidential information with the regulator, in order to reassure the airlines that the costs are justified.

This Commission Paper has used the term user and airline interchangeably, but the Commission acknowledges that the interests of other users, and not just airlines, are important. In many instances, the Commission would expect that airlines, while motivated by a desire to maximise returns for their shareholders, will nevertheless have overlapping interests with their passengers in terms of their aspirations for investments at Dublin Airport or by the IAA. Where the regulated company believes

that this is not the case, it will be incumbent on it to demonstrate that passengers support an investment, with the consequent implications for charges. Such evidence could, if appropriate, take the form of a passenger survey and empirical analysis of the results. The survey results could then form the basis for a thorough cost-benefit analysis of the project. If the regulated company is to provide a compelling case for a project based on such survey evidence, then it should engage with the Commission and the airlines in drawing up the terms of reference for such a survey, to avoid a situation whereby the results of the survey are immediately dismissed as meaningless. More generally, the Commission will always be willing to discuss with regulated companies what evidence might demonstrate that airlines' objections to investment plans conflict with the interests of other users including passengers.

### **3.3 Guidelines for different project drivers**

A key ingredient to ensure successful consultation on a given project is that all parties understand the rationale for a project: what the project driver is. Both the regulated company and the users need to agree on why the project is needed.

The Commission has identified the following five headings which capture the rationale for most, if not all, capex plans:

- Replacing obsolete facilities
- Increasing capacity
- Improving the quality of service
- Reducing operating costs
- Satisfying safety or other legal requirements

Some projects might be motivated by more than one project driver. For example, when replacing an obsolete asset, the regulated company might also take the opportunity to consider upgrading the quality of service it provides.

Before replacing an asset that has become **obsolete** or is in need of significant maintenance work because it has become run-down there are a number of questions that the regulated entity might discuss with airlines. Most fundamentally, is it worth replacing the asset? Restating the question, how much are users willing to pay to replace the asset? If it will cost more to replace than this sum, then there is no point proceeding with the capex. If users do want the asset replaced, then there should

be more detailed discussions about how much it is likely to cost. This might include reference to benchmark projects undertaken elsewhere. The parties might also discuss if they want to use this opportunity to upgrade (or downgrade) the functionality of the asset being replaced. Where there are considerable differences in the cost of replacements, depending on the level of functionality selected, the regulated company and airlines should seek to reach an agreement on the preferred option with rough costings for significantly different functionality offerings. Thereafter, the regulated company might develop more detailed costings for the preferred option. If these prove to differ substantially to the rough costings, the regulated company should be open to the possibility that users will prefer to reconsider their original support for an asset with that level of functionality. When presenting costs, the regulated company should explain how it proposes to recover the costs throughout the lifetime of the asset.

For projects motivated by a need to respond to increased demand for **capacity**, the primary issue for consultation will be establishing whether the demand projections warrant the expansion. Before making detailed investment plans, the regulated company and the airlines should agree the increment of additional capacity that needs to be provided. This is especially important if the regulated company wants airlines to bear the risk of demand out-turns being below projections. Thereafter, the regulated company should develop costings for how to provide that additional capacity, again allowing the airlines an opportunity to comment on what the quality of service associated with the additional capacity should be given the different cost implications. Again, parties should be open to revisiting decisions if earlier estimates of costs prove on further analysis to have been unrealistic, or if the demand projections no longer seem robust. The consultation will be unsatisfactory if airlines are presented with a “take-it-or-leave-it” capacity expansion plan with any options for discussion having relatively minor implications for the overall costs of the project.

Investments to improve the **quality of service** should only proceed if users have had an opportunity to agree that any additional costs are more than compensated for by the improved service. This Commission Paper has previously outlined the types of questions that might be addressed if there are differences of opinions amongst airlines concerning the appropriate trade-off between price and quality of service. During the consultation, a default option that should be considered is a “do-nothing option”. If the upgrade, with incremental costs, is not an improvement on the status

quo, then the capex is not necessary and should not proceed. The regulated company should also be open to suggestions about alternative investments that might provide an improved quality of service, either greater than or less than the original improvements envisaged by the regulated company. The consultations should consider whether there is a cheaper means of realising the same quality improvements.

In some instances capex might enhance overall efficiency by **reducing net operating costs**. To demonstrate the cost savings, the regulated company should outline to users what its net operating expenditure is likely to be with and without the asset for the lifetime of that asset and what guarantees it can provide that the investment really will provide savings to users over the lifetime of the asset. Where such savings can be demonstrated, it is unlikely that users will object to the investment, although they may be able to identify further cost savings.

There may be some capex projects where the regulated entity has no discretion but to undertake, because of **safety or other legal requirements**. This does not remove the requirement for consultation with users. The regulated company should explain why a project needs to proceed and its likely cost, and be open to suggestions of more effective ways of satisfying the requirements. Presenting users with details late on in the development of the project and claiming that there is no time to countenance major revisions to the plans because of the statutory obligations is inconsistent with the goal of constructive consultation.

On the next page is a worked example of how the consultation might work for a project to build a new ATC tower. It includes a discussion of how the work might feed into the regulatory price cap reviews.



## **Box 1: Example of a Consultation Process - proposals for a new control tower**

### **Stage 1: Establish working arrangements**

- Establish forum for the discussions on the building of a new tower.
- Agree the timetable for various meetings and the key personal who will participate in the process.
- At this stage in the process, and for certain types of projects, some airlines may feel that the project is not of direct benefit to them and might therefore indicate their lack of support for the project, as well as choosing not to participate further in discussions. In this case, it is unlikely that a Tower might not be relevant to every user.

### **Stage 2 – Project drivers and options for delivery**

- The regulated company provides the rationale – the project driver(s) – for the investment. For a new air traffic control tower, a likely motivation will be that the current facility is or will become in the near future obsolete.
- Assuming parties accept that the status quo is not a viable option, they will need to agree on what exactly is required from a new tower. This may require discussion on what equipment and the number of personnel that the tower will be expected to hold, which may itself be a function of more fundamental questions about the forecast number of ATMs at the airport that should be planned for and what technologies should be used.
- If the parties agree on the project drivers, and the need for the project, the next task is to set out the options for delivery of the project, and how the costs and timetable might vary according to the option chosen. The different cost options should also be linked directly to the resulting charges that airlines will have to pay. In this example Eurocontrol and ICAO prescriptions may restrict the options available.

### **Stage 3 – Commission review of the consultation process**

- At the time of the next Determination, the Commission will review the capex consultation process. It will seek evidence of open and transparent consultation on the different issues, including the cost implications. Were the informational requirements of the various parties reasonable, and were they satisfied in a timely manner? Did the regulated company address concerns raised during the consultation (either by amending plans or providing reasons why it was continuing with its initial plans)?
- Following the review, the Commission will decide whether it needs to conduct a detailed assessment of the capex plans for the tower. If the Commission concludes that the consultation process was satisfactory, then it will encourage the parties to come to a final agreement on a timetable for delivery of the project, the costs for the project, and how they might be recovered.
- Where the consultation has resulted in no agreement the Commission will review whether the parties have consulted in good faith – that is, whether parties have genuinely sought to find a solution to a given problem. If the Commission concludes that the regulated company attempted to consult constructively, but that a subset of users did not, it will review the costs and rationale for the project with a view to including it in the price-cap calculations. But if the Commission concludes that the regulated company failed to consult constructively, it is unlikely to include an allowance for the project in the RAB, instead advising the regulated company to consult better with users.

#### **4. CONCLUDING COMMENTS**

The Commission believes that there are likely to be significant benefits to all parties from working towards an open and transparent consultation process on future capex requirements in relation to airport services delivered by the DAA and IAA. Too often in the past, the inability of the regulated companies and the airlines to come to an agreement on capex requirements has led to a detailed, resource-intensive examination of the regulated companies' capex plans by the Commission. The Commission believes that this represents a second-best solution to capex planning. It hopes that the capex guidelines presented here set out a framework for successful consultation on future capex plans between the regulated companies and their users.

These guidelines do not remove the Commission's overall statutory obligations and the need to exercise judgement about capex. Instead they aim to signal where the Commission hopes the boundary between commercial negotiations and regulatory intervention can lie, and consequently reduce the number of times that the Commission needs to exercise such judgement. If successful, they afford regulated companies an opportunity to manage their operations with less regulatory interference.

Feedback on these guidelines is welcome.<sup>2</sup> However, the impetus going forward is on the regulated companies and the airlines to develop and agree on a suitable set of guidelines, as well as on the institutional arrangements for future successful consultation. As the Commission has indicated, the regulatory burden associated with developing and implementing investment plans will be reduced if the parties are able to engage in constructive consultation. The Commission is reluctant to dictate the precise terms of any given consultation process; such discussions are most efficiently undertaken by the parties that are directly affected. However, where there are clear benefits to all parties from the Commission becoming more directly involved, either in commenting on the development of the guidelines or assisting in setting up the relevant fora, the Commission is willing to enter the debate.

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<sup>2</sup> Please send comments to Reamonn Lydon by email ([info@aviationreg.ie](mailto:info@aviationreg.ie)) or by mail to the Commission for Aviation Regulation, 3<sup>rd</sup> Floor, Alexandra House, Earlsfort Terrace, Dublin 2

## **APPENDIX: LESSONS FROM THE UK EXPERIENCE OF CONSTRUCTIVE ENGAGEMENT**

This section summarises the UK experience with constructive engagement at BAA's London airports. In May 2005 the CAA published a policy paper entitled "Airport Regulation: the process for constructive engagement". This paper set out the regulatory approach the CAA proposed to adopt at all future price control reviews.<sup>3</sup> At the core of this 'new regulatory approach' was a desire on the part of the regulator to see airports and airlines engage in more constructive discussions on future investment requirements at a given airport. Like the approach being espoused by the Commission in the current document, the CAA's aim was to avoid a situation of largely regulator-led debate on allowed capex in favour of one where the regulated companies and airlines agreed the major components of the capex plan. The CAA stated that

"the normal business of commercial airport/airline interaction should be reinforced by the regulatory process, rather than interrupted by it."

The CAA policy paper included explicit guidance on the nature and substance of the consultation on capex plans that it expected to see between the regulated companies and the airlines. For example, the CAA stated that the negotiations between airports and airlines should seek to identify the following for the purposes of capex planning:

- volume and capacity requirements;
- nature and level of service outputs;
- the nature and scale of the capex programme; and
- the efficient level of future capital expending associated with the capex programme.

The CAA guidance also allows for the possibility of airports-airline negotiation of financial incentives with respect to the delivery of agreed service quality, capacity enhancements and other types of investment.

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<sup>3</sup> The paper drew on the output from a number of previous consultations with industry stakeholders, notably the "Agreement with BAA on enhanced information disclosure and consultation", UK CAA February 2003, pages 95 - 97, Annex 4 of CAA Decision on "Economic Regulation of BAA London Airports: 2003 - 2008".

In December 2006, the CAA initiated an independent review of the process of constructive engagement at the three BAA London airports – the 'Cotterill Review'.<sup>4</sup> The Cotterill Review concluded that in building on the CAA's constructive engagement proposals, there had been some improvement in the consultation process at both Heathrow and Gatwick. However the Review found that there had been limited progress at Stansted Airport, and the consultation process had been largely deadlocked since its inception. Cotterill noted that one of the reasons for the deadlock at Stansted was the inability of BAA and the airlines to come to an agreement on the information requirements as set out in the CAA guidance on constructive engagement.

Drawing together the observations and conclusions in the Cotterill Review, it is possible to come up with a list of key learning points from the UK experience.<sup>5</sup> These are summarised in the table below.

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<sup>4</sup> "Review of BAA's Compliance with Annex 4 of CAA's Decision of February 2003", UK CAA, December 2006, by Bob Cotterill.

<sup>5</sup> See section 9, pages 78 – 81 of the "Review of BAA's Compliance with Annex 4 of CAA's Decision of February 2003", UK CAA, December 2006, by Bob Cotterill.

	<b>Conclusions from the Cotterill Review of the process of constructive engagement at BAA's London Airports</b>
Airports need to...	<ul style="list-style-type: none"> <li>• ensure a common understanding with the airlines of the benefits of constructive engagement, and the behaviour needed to deliver it.</li> <li>• develop a business philosophy that aligns the creation of shareholder value with the creation of value for airline customers.</li> <li>• develop a long-run strategic development process in which the airlines are fully engaged.</li> <li>• ensure a transparent process and clear programmes for involving airlines in the development of airport strategies and decision making.</li> <li>• ensure the participation of senior management who are committed to making the relationships a success.</li> </ul>
Airlines need to...	<ul style="list-style-type: none"> <li>• approach the process in an open and transparent manner, and in a spirit of mutual trust between all parties.</li> <li>• understand that the nature of the constructive engagement is that it requires active participation and information disclosure from the airlines as well as the airport.</li> <li>• take an active role in agreeing the programme for engagement - that is, where and when meetings will take place, and what exactly the critical issues for discussion will be at each meeting.</li> <li>• actively monitor the success or otherwise of the process of constructive engagement, providing coherent feedback to the regulator on how it is working, and where it could perhaps work better.</li> </ul>
The regulator needs to...	<ul style="list-style-type: none"> <li>• provide clarification on, and commitment to, a regulatory framework going forward.</li> <li>• have a clear view on what 'compliance' with the guidelines actually means in practice.</li> <li>• continually review the success or otherwise of the process of constructive engagement.</li> <li>• view airport/airline dialogue as an evolutionary process – there may be a role for the regulator in providing for the continued development of the capex guidelines as the process matures.</li> </ul>

*Source: "Review of BAA's Compliance with Annex 4 of CAA's Decision of February 2003", UK CAA, December 2006, by Bob Cotterill, pages 60 – 81.*