# Commission for Aviation Regulation's conclusions on the impact of the amendments to the Aviation Regulation Act, 2001, on the regulation of maximum levels of airport charges in Ireland

Commission Paper CP9/2004

22nd December 2004

Commission for Aviation Regulation
3rd Floor, Alexandra House
Earlsfort Terrace
Dublin 2
Ireland

Tel: +353 1 6611700
**Fax: +353 1 6611269**

**E-mail info@aviationreg.ie**

# TABLE OF CONTENTS

# 1. INTRODUCTION

On February 27, 2001, the Minister for Public Enterprise established the Commission for Aviation Regulation ("the Commission") under Section 5 of the Aviation Regulation Act, 2001 ("the 2001 Act"). Under the Act, one of the principal functions of the Commission is the making of a determination on maximum airport charges.

Under the 2001 Act, the Commission was required to make a determination specifying the maximum levels of airport charges that may be levied at Dublin, Cork and Shannon Airports. In setting maximum airport charges, the objective set out for the Commission was to facilitate the development and operation of cost effective airports, which meet the requirements of users. This was characterised by the Commission as the "statutory objective". In arriving at its determination, Section 33 of the Act required the Commission to have due regard to ten specified factors. These were termed by the Commission the "statutory factors".

The State Airports Act, 2004, (the "2004 Act") amended the 2001 Act in a number of respects, including amending the provisions relating to the economic regulation of airports. The 2004 Act requires the Commission "as soon as is practicable, but not later than 12 months after the Dublin appointed day" to make a new determination specifying the maximum levels of airport charges that may be levied at Dublin Airport, alone. This new determination will effectively super-cede the current determination made by the Commission in August 2001 and reviewed in March 2004.

The 2004 Act has also amended the regulatory objectives of the Commission in setting airport charges. In particular section 22(4) of the 2004 Act substitutes a new section 33 into the 2001 Act. Section 33 relates to the statutory objectives of the Commission when making a determination on airport charges and also to the factors to which it must have due regard when making a determination. In addition, the scope of the 2001 Act has been restricted by the 2004 Act. The Commission must now make a determination specifying the maximum levels of airport charges that may be levied by Dublin Airport Authority ("DAA") in respect of Dublin Airport only. Cork and Shannon airports have thus been removed from the remit of the Commission regarding airport charges.

## 1.1 Purpose of Commission Consultation Paper CP7/2004

Commission Consultation Paper CP7/2004, published on 1st October 2004, discussed the amended statutory objectives and factors to which the Commission shall have due regard as set out in section 33 of the 2001 Act, as substituted by section 22(4) of the 2004 Act. It invited submissions from interested parties as to how the Commission should interpret its amended statutory objectives and the factors to which it must have due regard when making a new determination. In doing so, the paper summarised the way in which the Commission interpreted its statutory mandate under the 2001 Act when making the existing Determination. This paper responds to submissions made to the Commission as part of that consultation process and sets out the Commission's considered position on how it should implement the revised provisions of section 33 of the Aviation Regulation Act, 2001 and any other provisions in the 2004 Act relevant to the Commission's amended mandate. In particular, it represents the Commission's view on whether, as a result of the new legislation, it is required to adopt a new approach when making a determination. Consequently, future determinations will reflect the interpretation as adopted by the Commission on the issues set out in this paper.

# 2. AMENDMENTS TO SECTION 33 OF THE AVIATION REGULATION ACT 2001.

## 2.1 Overview of the amendments to section 33.

Throughout this section the amendments introduced by the State Airports Act, 2004 to the Aviation Regulation Act, 2001 are presented in tables, for ease of reference. In all of the tables, a blank box opposite a subsection in one Act means that there is no corresponding subsection in the other Act. For example, certain subsections in the 2001 Act have been repealed but not replaced, whilst others subsections set out in the 2004 Act are appearing for the first time.

| 2001 Act | Substitution as set out in the 2004 Act |
|---|---|
| the Commission shall aim to facilitate the development and operation of cost-effective airports which meet the requirements of users | (1) the objectives of the Commission are as follows –<br>(a) to facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and prospective users of Dublin Airport,<br>(b) to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport, and<br>(c) to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner |
| And shall have due regard to - | (2) In making a determination, the Commission shall have due regard to |

| 2001 Act | Substitution as set out in the 2004 Act |
|---|---|
| | a) the restructuring including the modified functions of Dublin Airport Authority, |
| a) the level of investment in airport facilities at an airport to which the determination relates, in line with safety requirements and commercial operations in order to meet current and prospective needs of those on whom the airport charges may be levied | b) the level of investment in airport facilities at Dublin Airport, in line with safety requirements and commercial operations in order to meet the needs of current and prospective users of Dublin Airport, |
| b) a reasonable rate of return on capital employed in that investment, in the context of the sustainable and profitable operation of the airport | |
| c) the efficient and effective use of all resources by the airport authority | |
| d) the contribution of the airport to the region in which it is located | |
| e) the level of income of the airport authority from airport charges at the airport and other revenue earned by the authority at the regulated airports or elsewhere | c) the level of operational income of Dublin Airport Authority from Dublin Airport, and the level of income of Dublin Airport Authority from any arrangements entered into by it for the purposes of the restructuring under the State Airports Act, 2004 |
| f) operating and other costs incurred by the airport authority at the airport | d) costs or liabilities for which Dublin Airport Authority is responsible, |

| 2001 Act | Substitution as set out in the 2004 Act |
|---|---|
| g) the level and quality of services offered at the airport by the airport authority and the reasonable interests of the users of these services | e) the level and quality of services offered at Dublin Airport by Dublin Airport Authority and the reasonable interests of the current and prospective users of these services, |
| | f) policy statements, published by or on behalf of the Government or a Minister of the Government and notified to the Commission by the Minister, in relation to the economic and social development of the State, |
| h) the cost competitiveness and operational efficiency of airport services at the airport with respect to international practice, | g) the cost competitiveness of airport services at Dublin Airport, |
| i) imposing the minimum restrictions on the airport authority consistent with the functions of the Commission, and | h) imposing the minimum restrictions on Dublin Airport Authority consistent with the functions of the Commission, and |
| j) such national and international obligations as are relevant to its functions | i) such national and international obligations as are relevant to the functions of the Commission and Dublin Airport Authority. |

The State Airports Act, 2004 also amends the Aviation Regulation Act, 2001, by defining a number of terms referred to in that Act and how they are to be understood for the purposes of making a determination under the Aviation Regulation Act, 2001.

As defined by section 4, Part 2, of the, 2004 Act, "restructuring" means:

" the doing of all things as are necessary for the purposes of giving effect to this Part, and, in particular to sections 7 and 8, in providing for full legal autonomy and independence of each of Dublin Airport Authority, Cork Airport Authority and Shannon Airport Authority."

In addition, "user" has been defined at section 22(5) of the 2004 Act as meaning any person –

(a) for whom any services or facilities the subject of airport charges are provided at Dublin Airport,

(b) using any of the services for the carriage by air of passengers or cargo at Dublin Airport, or

(c) otherwise providing goods or services at Dublin Airport."

"Operational income" is defined in section 22(5) of the 2004 Act as follows:

"operational income includes airport charges and commercial revenues associated with the operation of Dublin Airport."

2.1.1 <u>Summary remarks on the Statutory Objectives</u>

Having regard to the provisions contained in the 2004 Act and in light of the nature and purpose of economic regulation, the Commission is of the view that the new statutory objectives permit the continuation by the Commission of the regulation of airport charges imposed at Dublin Airport by DAA by reference to the economic concepts of productive, dynamic and allocative efficiency.[1] As set out below, these concepts continue to promote the statutory objectives of the Commission, as amended. By directly stating the Commission's objective as being to facilitate the efficient and economic

[1] The Commission notes that the Competition Authority in its response to CP7/2004 agrees with this approach.

development and operation of Dublin Airport, the amendment has strengthened the emphasis on economic efficiency as a principle of airport charges regulation. In addition to the statutory objective, the Commission has to have due regard to a number of factors, which have also been amended by the 2004 Act. Three of the statutory factors set out in s. 33 of the 2001 Act, have been deleted. Two of those deleted factors have, in the Commission's view, been subsumed into statutory objective (a). They are the statutory factor at section 33(b) of the 2001 Act regarding a reasonable rate of return on capital employed and the statutory factor at section 33(c) on the efficient and effective use of all resources by the airport authority. The third deleted factor refers to the importance of the airports to the regions and has been deleted from the statutory factors without being substituted by or subsumed into any other section of the Act; henceforth only Dublin Airport is to be subject to price regulation.[2] The amendments to the remaining factors represent minor changes that should not necessarily require any significant change to the existing price cap methodology.

It is clear from the responses of interested parties that there are a number of issues on which there is general agreement with the Commission's approach. There are also areas where consensus is less apparent. Set out below, in turn, are the main issues on which, firstly, consensus and, secondly, concern were indicated.

The Commission agrees with DAA that in order to attain the objectives, the level of allowed revenue must be sufficient to develop airport facilities in line with the reasonable requirements of both current and prospective users. The Commission is of the view that the efficient investment behaviour including that motivated by the pursuit of long-term cost savings, promotes the requirements of both current and prospective users of the airport services and facilities and is encapsulated in the economic principle of dynamic efficiency.

---

[2] When making its determination of August 2001, the Commission received a Ministerial direction pursuant to section 10 of the Act, directing it to make every reasonable effort to ensure that its final determination reflected the important emphasis which the Government has placed on balanced regional development.

The Commission agrees with Aer Lingus that the changes to the legislation do not require any significant change in its approach to the regulation of airport charges. As stated in its submission, Aer Lingus notes the changes are characterised as either the promotion of certain statutory factors into statutory objectives or the clarification of wording used in the legislation describing the Commission's role. The Commission agrees that the 2001 Act, as amended, requires it to treat the three statutory objectives with equal importance. The Commission notes the view of the Irish Association of International Express Carriers (IAIEC) that it is the Commission that must strike an effective balance between its altered statutory objectives.

The Commission supports the British Midland (BMI) view that consultation between the airports and the airlines is necessary for the drafting of a "viable business plan and to deliver the service standards and quality of facilities required by airlines."

The Commission notes Ryanair's qualified support for the continuation of incentive regulation and its desire that DAA receives incentives to improve their efficiencies and reduce costs.

As mentioned above there are topics where the views of interested parties differ from those of the Commission.

DAA states that one of the statutory objectives of the 2001 Act as amended explicitly requires its financial sustainability to be "assured". The Commission is of the view that this objective requires particular explanation given that it has the potential to attract a high degree of misunderstanding. The statutory objective requires the Commission to enable DAA to operate and develop Dublin Airport in a sustainable and financially viable manner. The Commission's understanding is that the correct and most appropriate interpretation of this mandate is to provide DAA with the means to make it possible to operate and develop Dublin Airport in a sustainable and financially viable manner. That objective does not equate with making certain that this happens nor is it within the power of the Commission to do so.

Furthermore, DAA asserts that the changes set out in the 2004 Act give precedence to the third statutory objective, (c), over the other two. The Commission does not agree with this view.

When taking into account the level of income of the airport operator the air carrier respondents favour the exclusive use of a single till. DAA advocates the use of a dual till but accepts the use of a single till in certain conditions. It is the Commission's view that it should continue to use a single till approach in the forthcoming determination but may consider the use of a dual till in the future. This issue is discussed in more depth at paragraph 2.3.6.

Both DAA and BMI are opposed to the use of off peak landing charges in the manner heretofore determined by the Commission. The Commission notes the comments by IAIEC in regard to the implementation of the cargo sub-cap provided for in the original determination.

Ryanair's general position on the process leading to the making of a new determination is that it "is entirely redundant considering that yet a further determination will be necessary once the break-up of the Irish airports occurs next year."

## 2.2 Section 33 – Objectives

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| the Commission shall aim to facilitate the development and operation of cost-effective airports which meet the requirements of users | (1) the objectives of the Commission are as follows –<br>(a) to facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and prospective users of Dublin Airport,<br>(b) to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport, and<br>(c) to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner |

### 2.2.1 Objective in 2001 Act

The Commission's interpretation of this statutory objective was set out in CP2/2001, which is available on the Commission's website[3] www.aviationreg.ie

In interpreting the statutory objective, the Commission equated:

1. The operation of cost effective airports with the concept of productive efficiency, i.e. service provision at minimum cost;

---

[3] http://www.aviationreg.ie/downloads/processforaircharges2.pdf

2. The development of cost effective airports with the concept of dynamic efficiency, i.e. efficient investment behaviour motivated, in particular, by the pursuit of long-term cost savings;

3. Requirements of users[4] with the concept of allocative efficiency, i.e. all users who are willing to pay for the service have access to it subject to the regulated firm covering its efficiently incurred costs.

In doing so, the Commission was guided by the proposition that (i) well-functioning competitive markets are characterised by these three types of economic efficiency; and (ii) that regulators responsible for the regulation of market power typically seek to emulate the workings of competitive markets.

Where the three economic efficiencies (productive, dynamic and allocative) are observed, economic welfare (the excess of the value of producing a good or service over its production cost) is maximised.

Therefore, the implementation of the statutory objective contained in the Aviation Regulation Act, 2001, obliged the Commission, in its view, to determine airport charges in a manner that would maximise economic welfare through the pursuit of productive, dynamic and allocative efficiency.

### 2.2.2 Objectives in the 2001 Act as amended.

The statutory objective has been amended as follows:

s. 33(1) - "in making a determination, the objectives of the Commission are as follows-

(a) to facilitate the efficient and economic development and operation of Dublin Airport which meet the requirements of current and prospective users of Dublin Airport,

---

[4] The Commission equated users in the original determination of August 2001 with consumers of airport services. The term is now defined at section 22(5) of the State Airports Act, 2004.

(b) to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport

(c) to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner.

Undoubtedly, with reference to subsections (a) and (b), the objective to promote efficiency has been strengthened by the amendment. Subsection 33(1)(c) is an entirely new provision which seeks to promote a viable airport. All the objectives must be read together and in light of each other.

In interpreting these objectives the Commission equates:

1. productive efficiency with the reference in (a) to the efficient and economic operation of Dublin Airport;

2. dynamic efficiency with the reference in (a) to the efficient and economic development of Dublin Airport to meet the requirements of prospective users, the reference in (b) to protecting the reasonable interests of prospective users, and the reference in (c) to enabling an efficient operator of Dublin Airport to operate and develop the airport in a sustainable and financially viable manner;

3. allocative efficiency with the reference in (a) to meeting the requirements of current users, and the reference in (b) to protecting the reasonable interests of current users.

Clearly, the economic efficiency principles adopted in making the original determination remain valid. The Commission notes the view of Aer Lingus that setting airport charges that seek to maximise these efficiencies remains the best way for the Commission to meet the amended statutory objectives.

The previous objective of facilitating the development and operation of cost effective airports, which meet the requirements of users, has in essence been retained in the new statutory objective (a), but clarified to refer to the efficient and economic development and operation of Dublin Airport to meet the requirements of current and prospective users. The Commission concludes that the new explicit reference to the efficient and economic operation and development of Dublin Airport strengthens the basis for its view that the essence of its statutory mandate is to promote economic efficiency. In addition to strengthening the basis for its approach of promoting economic efficiency, objective (a) can also be seen as a replacement of the previous Section 33(b) of the 2001 Act, which required the Commission to have due regard to the regulated company earning a reasonable rate of return on capital employed. Providing for a reasonable rate of return encourages the entity providing the regulated services to make efficient decisions regarding the amount of capital to invest in the regulated activities.

The Commission, therefore, agrees with DAA that in order to attain objective (a), the level of allowed revenue must be sufficient to develop airport facilities in line with the requirements of both current and prospective users. This, according to DAA, requires the Commission to allow:

- an adequate return of and return on existing assets employed in the operation of the airport;
- the recovery of efficiently incurred operating costs; and
- sufficient levels of recoverable capex to ensure that the airport is capable of financing its capital programme.

DAA also argues that the term "user requirements" should be interpreted as referring, not only to physical infrastructure, but also to a safe and secure operating environment and the provision of appropriate levels of service quality. The Commission agrees that safety, security and levels of service and quality are encapsulated by the reference to meeting user requirements in the pursuit of objective (a) but also by the reference to protecting the reasonable interests of current and prospective users in objective (b).

With regard to statutory objective (b),

"*to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport",*

DAA argues that the inclusion of "prospective users" in the statutory objective is a key change from the previous narrower provision and that it will facilitate a broader and more long-term approach to be adopted when examining user requirements.

The Commission previously interpreted "meeting the requirements of users", with regard to allocative efficiency, where all users willing to pay the efficient cost of a service have access to it (or can be expected to have in the future). In this manner one may also interpret "reasonable interests of users".

In addition, providing for the regulated firm to earn a reasonable rate of return on capital employed in investment should enable the sustainable and financially viable operation and development of the airport and is thus in the interest of users. This approach, which is motivated by dynamic efficiency considerations, best meets the newly framed statutory objective, having regard to the level of investments in line with safety requirements and commercial operations in order to meet current and particularly prospective needs of users. In this regard statutory objectives (a) and (b) are closely linked. The efficient and effective use of resources is discussed further at paragraph 2.3.4.

The Commission's third statutory objective (c), is,

"*to enable Dublin Airport Authority to operate and develop Dublin Airport in a sustainable and financially viable manner*."

The Commission acknowledges that statutory objective (c) is a new provision in section 33 as substituted by the 2004 Act. This objective requires the Commission, in making its determination, to enable the sustainable and financially viable operation and development of Dublin Airport by DAA. This objective must be read together with and in light of the other two statutory objectives. The Commission is of the view that it should attain this statutory objective (c) while also providing incentives for DAA to operate and develop in an efficient and economic manner while protecting the reasonable interests of users.

The Commission does not consider the objectives of efficiency, sustainability and financial viability to be necessarily contradictory. As indicated above, the Commission considers that statutory objective (a) may be met, at least in part, by providing the regulated firm with a reasonable return on its assets. In addition, the Commission is of the view that the use of an incentive-based price cap will encourage the regulated firm to maximise its retained earnings by seeking efficiencies, thereby enabling it to be sustainable and financially viable. Accordingly, the Commission considers that principles of economic efficiency when applied to the making of a determination will contribute to enabling the regulated firm to be sustainable and financially viable.

DAA argues that this third statutory objective should be regarded as the pre-eminent objective. The Commission is of the view that the 2004 Act does not confer such a status on the third objective. Furthermore, the objective given to the Commission is to "enable" the company to be sustainable and financially viable – not to assure or ensure such an outcome in all circumstances or in such a manner as to override the two other stated objectives. Such a view is supported by the Competition Authority, which considers that this objective does not imply that "the firm cannot be allowed to go bankrupt as a result of inefficiency and mismanagement." As stated in its response to CP7/2004 it is in the long-term interests of users to allow an inefficient firm to go bankrupt so that a new and more efficient firm can take over the provision of the services at lower prices. While the economic theory supporting that statement is correct, clearly such an outcome is undesired. The Commission's view is that its objective is to provide DAA with the means to make the operation and development of Dublin Airport in a sustainable and financially viable manner possible. Attaining this objective must be by reference to the other statutory objectives. The Commission is of the view that equal weight must be given to all three objectives.

DAA also argues that this third statutory objective requires that the Commission provide the regulated firm with a reasonable rate of return on capital. As stated previously, the Commission is of the view that the first statutory objective requires the Commission in the making of a determination to provide the regulated firm with a reasonable rate of return on assets as this is intrinsically bound up with the concept of economically efficient development and dynamic efficiency. Furthermore, the Commission is of the view that the third objective of enabling sustainability and financial viability is, in certain circumstances, a lower standard of financial protection to the regulated firm than the first, as it could in effect be met by the Commission simply making a determination that allows the regulated firm to remunerate its debts without paying a full return to its shareholders.

In addition, DAA argues that the third statutory objective requires the Commission to test the financial robustness of its regulatory proposals. The Commission accepts this representation in the context of measuring the financial risks likely to face a regulated firm operating in an efficient manner. Accordingly, the Commission considers it appropriate in the making of a determination to undertake a separate risk analysis of the regulated firm in order to be able to form a view that the regulated firm is enabled to be financially viable throughout the course of the regulatory period.

The Commission notes the Aer Lingus submission that, "the Commission should not seek to ensure that the Authority recovers its weighted cost of capital in each year, as this is not required for the Authority to be financially viable and would be expected to undermine its incentives to achieve and maintain productive and dynamic efficiency." As mentioned above, one should note that the wording of this objective in the Act is to "enable" not to "ensure" or "assure."

The topic of providing a reasonable rate of return on capital employed is discussed further at paragraph 2.3.3.

### 2.3 Section 33 - Statutory Factors

The Commission is directed to have due regard to a number of factors specified in Section 33. These factors have now been amended as follows:

2.3.1 <u>The Restructuring</u>

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| and shall have due regard to - | (2) In making a determination, the Commission shall have due regard to |
| | a) the restructuring including the modified functions of Dublin Airport Authority, |

This is an entirely new provision.

One should note, however, that having regard to the fact that the Cork and Shannon appointed days shall not be earlier than the 30th April 2005, this sub-section does not apply in relation to the first determination made after the Dublin Appointed Day.[5]

As defined by section 4, Part 2, of the 2004 Act, "restructuring" means:

"the doing of all things as are necessary for the purposes of giving effect to this Part, and, in particular to sections 7 and 8, in providing for full legal autonomy and independence of each of Dublin Airport Authority, Cork Airport Authority and Shannon Airport Authority."

Restructuring within the meaning of the Act takes place once Cork Airport Authority and Shannon Airport Authority are vested with the responsibility of

[5] Section 33(3) of the Aviation Regulation Act, 2001 as substituted by the State Airports Act, 2004 states that, " having regard to section 5(2) of the State Airports Act, 2004, subsection 2(a) does not apply in relation to the first determination made after the Dublin appointed day."

owning and managing Cork Airport and Shannon Airport respectively. The vesting of these airports and the duty to manage, operate and develop them will occur on days known as their "appointed days". Section 5(2) of the 2004 Act states that the Cork and Shannon appointed days shall not be before the 30th April 2005.

Consequently, the Commission is directed by section 22(3) of the 2004 Act that, "having regard to section 5(2) of the State Airports Act, 2004 subsection 2(a) does not apply in relation to the first determination made after the Dublin appointed day."

In light of the foregoing, and the fact that the first determination pursuant to the new Act must be made by the 1st October 2005, the restructuring cannot be taken into account pursuant to section 33(2)(a) unless Cork and Shannon Airport Authorities are vested with the ownership and management of their respective airports within that time.

Determinations made after both Cork Airport and Shannon Airport Authority's appointed days will take the restructuring into account.

The Commission's views on the consequences for regulation of the restructuring are set out in Section 3 hereafter.

### 2.3.2 The level of investment

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| a) the level of investment in airport facilities at an airport to which the determination relates, in line with safety requirements and commercial operations in order to meet current and prospective needs of those on whom the airport charges may be levied | b) the level of investment in airport facilities at Dublin Airport, in line with safety requirements and commercial operations in order to meet the needs of current and prospective users of Dublin Airport, |

Given the primacy of safety in the context of aviation, the Commission stated in CP2/2001 that in carrying out economic regulation, it would assume that the regulated company continues to meet the safety standards set by the Irish Aviation Authority and to maintain a strong corporate safety culture.

In terms of commercial imperatives, the view remains that as airports are capital-intensive businesses, it is necessary that their economic regulation be consistent with a level of investment in facilities that allows the needs of users to be met. This includes the needs of prospective users. Consequently, long-term developments plans must be taken into account. Equally, investments in airport infrastructure can be very costly, and made against a background of considerable uncertainty as to future passenger demand and future economic conditions. Therefore, economic regulation must seek to avoid excessive or excessively early investments that have to be paid for by raising airport charges. As stated earlier, ensuring that the regulated firm would earn a reasonable rate of return on capital employed in investment, enabling the sustainable and financially viable operation of the airport is in the interest of users. This approach, motivated by dynamic efficiency, has regard to the level of investments in line with safety requirements and commercial operations in order to meet current and particularly prospective needs of users.

The level of capital investment (CAPEX) that is required at an airport will depend, inter alia, on the level of current and projected demand, desired improvements in quality and the age of the existing facilities. An assessment as to the required CAPEX programme and its efficiency is, therefore, a central element of the economic regulation of airports. Therefore, it is necessary that a regulated firm’s investment plans be carefully scrutinised as to their timing and efficiency.

The Commission agrees with DAA that having regard to this factor will support the attainment of the statutory objective of facilitating the efficient and economic development of the airport that meets the requirements of current and prospective users.

The Commission agrees that the appropriate measure of the required level of investment involves the identification of the level of funding needed to deliver the required level of service performance on the most cost effective basis. Similarly, establishing the needs of current and prospective users is a key requirement in having regard to this factor.

An effective capital planning process is in the interests of both the airport and its customers. The Commission notes that all respondents have mentioned the importance of consultation. Effective consultation between the airport authority and its customers is in the interests of all parties. While it is true to say that the concept of consultation is not the same as meeting the needs of users, the two concepts are related. Some consensus or approval as to the necessity of capital projects between DAA and the users of Dublin Airport would benefit all parties and the Commission in making a determination.

2.3.3 <u>A reasonable rate of return on capital employed</u>

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| b) a reasonable rate of return on capital employed in that investment, in the context of the sustainable and profitable operation of the airport | |

The Commission notes this factor has been deleted but is of the view that it has been subsumed into statutory objective (a). As mentioned earlier in the document the Commission is of the view that providing for a reasonable rate of return on capital employed is necessary. The Commission explained its policy on this matter in CP8/2001 by reference to the above factor. That policy remains valid and was stated thus:

"In order to have due regard to this factor (previously b), it is necessary for the Commission to focus on four critical factors, namely: the assets (that are used to provide services, the charges for which are regulated) to be included in the regulatory asset base (RAB); the value of that RAB; cost of capital; and the appropriate rate of return to be allowed to Dublin Airport Authority. Bearing in mind the statutory objective, the Commission must consider the extent to which its treatment of these four factors contributes to the maximisation of economic welfare. In this manner, the statutory objective may be obtained".

In the 2001 determination, the Commission expressed the view that "providing a reasonable rate of return to the airport operator on capital employed appropriately rewards the regulated firm for its investments, thereby supporting the company's ability to meet the future requirements of users".[6] The Commission deemed this factor as requiring it to establish, or estimate, the magnitude of three critical economic parameters:

- the value of capital employed in the business;
- the cost of capital to the airport operator;
- the appropriate rate of return on capital employed.

The Commission will continue this approach.

2.3.4 <u>The efficient and effective use of all resources</u>

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| c) the efficient and effective use of all resources by the airport authority | |

The Commission notes that this section has been deleted from the 2004 Act and is of the view that this factor has been subsumed into statutory objective (a).

[6] Report on the Determination of Maximum Levels of Airport Charges – Part 1, Report on the Reasons for the Determination', Commission Paper CP8/2001, 26 August 2001

Dublin Airport Authority argues that since this statutory factor (c) has been deleted from the amended legislation, there is no longer an explicit requirement to look at the efficiency and effectiveness with which Dublin Airport employs its resources. It argues that there is, however, a continuing obligation on the Commission to take account of the cost competitiveness of Dublin Airport (i.e. prices charged to users), which, according to DAA, of itself implies efficient use of resources.

In the Commission's view, the efficient and economic development of Dublin Airport means that productive and dynamic efficiencies must be achieved. Consequently, an analysis of the efficient employment of resources at Dublin Airport is not deleted from the statutory regime but rather has been subsumed into the amended objectives. In addition, meeting the requirements and protecting the reasonable interests of current and prospective users equates with the notion of allocative efficiency. Addressing matters of cost competitiveness will enable the airport to achieve greater operational efficiency.

### 2.3.5 Contribution of the airport to the region

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| d) the contribution of the airport to the region in which it is located | |

The Commission notes that this section has been deleted from the 2004 Act. It has not been replaced nor has it been transposed in identifiable form to another factor or objective. Therefore, the Commission is no longer required to have regard to this factor. In addition, one must note that the scope of the 2001 Act has been restricted by the 2004 Act. Cork and Shannon Airports no longer fall within the remit of airport charges regulation. The Commission may now only make a determination specifying the maximum levels of airport charges that may be levied by DAA in respect of Dublin Airport.

2.3.6 The level of income

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| e) the level of income of the airport authority from airport charges at the airport and other revenue earned by the authority at the regulated airports or elsewhere | c) the level of operational income of Dublin Airport Authority from Dublin Airport, and the level of income of Dublin Airport Authority from any arrangements entered into by it for the purposes of the restructuring under the State Airports Act 2004 |

As mentioned earlier in this document, "operational income" is defined in section 22(5) of the State Airports Act, 2004.

The Commission set out its policy on the dual till/single till debate in its first determination of August 2001. Although a single till was adopted, it was the Commission's view that certain income streams which had an insufficient nexus to the airport, e.g. Great Southern Hotels, should be excluded. The Commission intends to continue this approach when making its new determination. An additional feature introduced by the 2004 Act, is that the Commission must have due regard to any income arising from the restructuring.

As mentioned earlier in this Paper, the Commission recognises that most industry respondents support a continuation of the single till approach for different reasons but that DAA while advocating the adoption of a dual till accepts the use of a single till with certain conditions. Aer Lingus is of the view that the use of a single versus dual till approach is not a matter of the availability of appropriate accounting systems, but rather a matter of economic efficiency. BMI also favour the use of a single till exclusively.

The Commission's view is that it may consider the use of the dual till in the future as this allows it to determine airport charges with respect to operational income, which refers to both airport charges and commercial revenues.

### 2.3.7 Costs or liabilities

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| f) operating and other costs incurred by the airport authority at the airport | d) costs or liabilities for which Dublin Airport Authority is responsible, |

DAA views the amended factor as now including a much broader definition of costs and liabilities than were previously taken into account and could therefore encompass any costs and/or liabilities for which DAA is responsible. In having regard to this factor, it notes that it would therefore be necessary to consider any costs arising from restructuring arrangements entered into by it for the purposes of restructuring under the 2004 Act.

It further argues that the amendment of the statutory factor allows for the adoption of a long-term view, as some liabilities for which DAA is responsible (e.g. repayments on the Eurobond), will extend beyond the minimum period of the proposed Determination i.e. 4 years.

The Commission believes that the identification and valuation of the regulated firm's assets and the calculation of the return of those assets fully takes into account (and therefore has due regard to) the "liabilities" of the regulated firm as well as a long-term view of such liabilities. The first issue is addressed by calculating a regulatory asset base (RAB), which aims to value existing assets at their economic value, writing down inefficient investments in the past, and by ensuring that additions to the RAB over time only include efficient future investments. The second issue is normally addressed by setting the allowable return at the level of the firm's weighted average cost of capital (WACC).

The Commission agrees with Aer Lingus that the inclusion of liabilities in this factor does not affect the setting of efficient charges that only allow DAA receive a WACC on its RAB to recover its efficient costs. The Commission agrees that the addition of the DAA's debt into the RAB would be double-counting the DAA's debt while reducing incentives towards the achievement of an efficient capital base. Adjusting the manner in which airport charges are determined in order to recover debts from inefficient investment is inconsistent with the statutory objectives.

A business will ordinarily seek to recover, through its revenues, its operating costs plus a level of depreciation, which it will need to fund the renewal and replacement of business assets, plus an operating profit, which it will need to pay interest and dividends (as well as tax). Ordinarily for a business to be sustained, the level of profit, or return, must be high enough to encourage investors, both lenders and shareholders, to continue to finance the business's investment needs.

Reflecting this, regulators conventionally calculate the level of revenues required by a regulated business by adding together a reasonably expected or efficient level of operating costs (after deducting unregulated revenues), depreciation and a return on capital, calculated to generate a reasonably attractive overall rate of return for the providers of finance. Thus there are three components of cost: operating, depreciation and finance. The Commission's previous determinations under Section 33 of the 2001 Act incorporated all three of these components.

Where the 2001 Act required the Commission to have due regard to the costs incurred by the airport authority, the 2004 Act introduces the word "liabilities" and modifies the scope of the requirement to include any costs or liabilities that the airport authority is "responsible" for, rather than what is "incurred by the airport authority at the airport".

Firstly, the Commission must consider the question of liabilities. Generally, costs and liabilities are simply two sides of the same accounting double entry – when a cost is incurred, a liability is created which must be discharged.

Sometimes, as with the generality of trade liabilities, that liability is discharged quite quickly, but longer-term financial liabilities may also be interest-bearing, in which case the airport authority will be responsible for the associated interest costs. The discounted value of the consequent interest costs, including the cost of finance needed to fund repayments, will generally correspond to the value of the liability. The Commission therefore considers that it remains appropriate to consider the three components of cost – doing so will automatically take into account the liabilities.

Secondly, the Commission must consider the question of responsibility. In general, DAA will be responsible for the costs incurred by the airport authority at the airport. There are, however, two other situations that the Commission must consider:

- where costs are incurred by the airport authority other than at the airport; and

- where DAA is made responsible for costs (or liabilities) that it did not originally incur.

If costs incurred by the airport authority other than at the airport are incurred in furtherance of its duty to operate the airport, the Commission would expect to assess them alongside other costs in its calculations of permitted airport charges. However, if those costs are not attributable to DAA's airport operating activities, i.e. if there is insufficient nexus to the airport, the Commission must interpret its responsibility to have due regard to them in the light of its statutory objective to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport. Provided sustainability and financial viability is not at issue, the Commission would expect to treat these costs in the same manner as those associated with other activities such as Great Southern Hotels referred to in paragraph 2.3.6 above: marked down to zero in its determination of airport charges.

The other situation relates to costs (or liabilities) that were not incurred by DAA but which it is nevertheless made responsible for. Chiefly, this concerns the transfer of financial liabilities, or debt, (i.e. interest cost obligations) of Aer Rianta Teoranta (ART) to DAA.

Under the conventional building-block approach that the Commission has adopted, interest costs are not explicitly taken into account because they are implicitly taken into account in the calculation of the cost of finance. Under this approach, the cost of finance is determined as a reasonable rate of return (the cost of capital) on the total value of business capital, referred to as the Regulatory Asset Base. Debt thus represents a component of that business capital, with the residual being the implied value of the equity in the business.

In the 2001 determination and subsequent reviews, the Commission assessed the initial value of the Regulatory Asset Base separately for Dublin, Cork and Shannon airports with reference to the indexed net book value of the assets being used in those businesses. The expectation was that these values would be rolled forward taking account of the depreciation costs allowed for and new investment in fixed assets. In adopting this approach, the Commission had regard to regulatory practice in other sectors and in the airports sector in other countries and considers that it remains an appropriate methodology.

In the 2001 determination and subsequent reviews, it was not necessary or meaningful to attribute ART's debt to the individual airports – those obligations attached to the company not the separate businesses. Capital would be raised by the company, not the separate businesses, and thus the Commission considered the capital structure of ART as a whole. This was relevant to the assessment of the company's cost of capital (the WACC), the cost associated with raising new finance irrespective of which of the company's businesses had cash flows that would necessitate it. This company-wide WACC was applied to the RAB for each airport, which the Commission was able to assess with reference to the accounting value of the assets used in each business.

DAA inherits the assets of the Dublin airport business and financial liabilities of ART. In line with regulatory practice, the Commission intends to roll forward the value of the Dublin airport business, its Regulatory Asset Base. Under this approach, the effect of a transfer of ART's debt to DAA should be to create a capital structure for the company, determining how much of the total capital is made up of debt and how much of equity. The implied level of equity would be the residual of the Regulatory Asset Base[7] after taking account of the value of debt.

Clearly, the amount of debt in DAA will have an impact on the level of dividends that DAA can sustain. In general, the more of ART's debt that is retained by DAA rather than being transferred with the assets of Cork and Shannon airports in due course, the lower the scope for DAA's dividends. At the same time, there should be higher scope for dividends from the Cork and Shannon airport businesses. Overall, the effect on the shareholder's economic interest should be broadly neutral.

In considering the effect of this statutory factor, the Commission has noted the contents of the independent report by DotEcon, a firm of economic consultants, published with CP7/2004 and responses to the consultation, including the report prepared by another firm of economic consultants, National Economic Research Associates (NERA), for DAA. There is nothing in the reports from either firm of consultants that suggests that the methodology for valuing the Regulatory Asset Base is affected by the transfer of debt[8], although both firms considered that there could be an impact on the WACC. The Commission concludes that the transfer of debt to DAA has no direct bearing on the valuation of the Regulatory Asset Base but accepts that it may have an impact on the assessment of the reasonable rate of return. This issue is considered in more detail in section 3.3.1 below.

---

[7] Plus the net value of any business activities that are outside the regulatory 'single till', where there is insufficient nexus to the airport.

[8] Both firms argue that the transfer will affect the structure of capital as opposed to its regulatory valuation.

The Commission therefore considers that it will take full account of the interest costs (and indeed all the costs or liabilities) associated with the transfer of debt to DAA when it includes in its determination of airport charges a cost of capital on the value of the Regulatory Asset Base rolled forward according to an established methodology. That cost of capital will be assessed taking into account the weighted average cost of capital (WACC), expressed as a percentage which is then applied to the RAB. Therefore, the finance component of the total cost allowed for in a determination will reflect the level and proportion of debt within DAA.

### 2.3.8 Policy statements

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| | f) policy statements, published by or on behalf of the Government or a Minister of the Government and notified to the Commission by the Minister, in relation to the economic and social development of the State, |

This is an entirely new provision.

The Commission agrees with the DAA's response that it appears from the Act that it is only those policy statements that are specifically notified to the Commission by the Minister, which should be considered under this statutory factor.

As the IAIEC point out, this factor must also be read having regard to the statutory independence of the Commission as provided for in section 6 of the 2001 Act.

2.3.9 Cost Competitiveness

| 2001 Act | Substitution as set out in the 2004 Act |
|---|---|
| h) the cost competitiveness and operational efficiency of airport services at the airport with respect to international practice, | g) the cost competitiveness of airport services at Dublin Airport, |

This factor has removed explicit mention of international practice and operational efficiency. However, it is must be read in light of the statutory objective (a), which seeks the efficient operation of Dublin Airport. The efficient operation of Dublin Airport has now been re-stated with greater, as opposed to less, emphasis by its inclusion in statutory objective (a). Therefore, contrary to the representation by DAA it has more significance than cost competitiveness. Addressing matters of cost competitiveness will enable the airport to achieve greater operational efficiency. In relation to competitiveness, this does not exist in a vacuum and therefore comparators have been used in the past. This approach is not ruled in or out by the wording of the 2004 Act.

2.3.10 The level and quality of services

| 2001 Act | Substitution as set out in the 2004 Act |
|---|---|
| g) the level and quality of services offered at the airport by the airport authority and the reasonable interests of the users of these services | e) the level and quality of services offered at Dublin Airport by Dublin Airport Authority and the reasonable interests of the current and prospective users of these services, |

The Commission believes this factor to be self-explanatory.

The new factor (e) corresponds largely to the previous statutory factor (g) replacing the generic reference to any airport at which charges are regulated by the specific reference to Dublin Airport. In addition, the notion of users has been expanded to include current and prospective users, emphasizing the need for the regulatory framework to encourage efficient investment. This equates with the principle of dynamic efficiency mentioned earlier in this document. This supports the statutory objective of the development of incentive based airport charges that incorporate the interests of prospective users.

The Act now applying to Dublin airport only, there is no direction to alter policy and the essence of this factor is a restatement. In the new Determination, the Commission will attempt to define levels of quality of service standards to be incorporated in the Determination.

2.3.11 Minimum restrictions

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| i) imposing the minimum restrictions on the airport authority consistent with the functions of the Commission, and | h) imposing the minimum restrictions on Dublin Airport Authority consistent with the functions of the Commission, and |

The Commission is of the view that there is no change in policy needed regarding this factor. The Commission notes the opposition of DAA and BMI to the use of off-peak sub-caps. However, the imposition of different categories of charges is specifically provided for by section 32(5) of the 2001 Act. Accordingly, the Commission shall continue to use them as appropriate.

### 2.3.12 Obligations

| **2001 Act** | **Substitution as set out in the 2004 Act** |
|---|---|
| j) such national and international obligations as are relevant to its functions | i) such national and international obligations as are relevant to the functions of the Commission and Dublin Airport Authority. |

The Commission considers that this provision is self-explanatory and proposes no change in policy and notes the general support of all respondents to this view.

# 3. ECONOMIC VIEWPOINTS ON THE RESTRUCTURING.

As part of the consultation process the Commission published a report by the economic consultants DotEcon, entitled "Implications of the de-merger of the former Aer Rianta for the regulation of Airport charges in Ireland". This independent report was a device to stimulate debate on the economic issues raise by the changes introduced by the 2004 Act. DAA responded to this report with its own analysis set out in a paper prepared by National Economic Research Associates (NERA). Set out below is the Commission's response and its views.

## 3.1 Main points raised by Dublin Airport Authority.

The principal conclusion of DAA is that the position set out in the DotEcon report, i.e. that the restructuring does not, of itself, require any significant adjustment to airport charges in Dublin, is "unsupported".[9] This conclusion is drawn from the following five main arguments it advances in its report:

- arising from the financial restructuring, DAA's cost of capital could, according to NERA's calculations, increase by 0.3 percentage points or more;

- this possible increase in DAA's cost of capital does not represent inefficiency as it could be offset by benefits elsewhere. Even if it were inefficient, a decision to disallow it would lead to DAA's charges being set below its costs and such an outcome would itself have a negative effect on economic efficiency;

- it would be difficult for the Commission to reconcile its statutory objective requiring it to enable DAA to operate and develop Dublin airport in a sustainable and viable manner with any decision not to allow DAA to recover its full cost of capital;

---

[9] NERA Report, October 2004, Executive Summary page i.

- the Commission's other new statutory objective – to protect the reasonable interests of current and prospective users – also requires it to give significant weight to DAA's likely financial viability, as any threat to this would be likely to conflict with users' interests, and

- the implementation of DotEcon's recommended approach would be likely to lead the Commission to disallow some of DAA's costs because it would believe that the Government had made an inefficient decision. NERA felt that such an outcome would expose a potentially damaging inconsistency between the views of the Commission and the Government.

The core argument of DAA appears to be based on its belief that the restructuring of the former ART could lead to an increase in DAA's cost of capital and that, if it does, DAA should be allowed to recover this increased cost in full. As set out in Section 3.2 below, this point does not directly conflict with the position advanced in the DotEcon Report in relation to the treatment of DAA's cost of capital.

Here, the Commission is assessing what DAA's conclusions mean for its approach to the regulation of airport charges generally.

Before discussing this, it is worth noting the significant areas in which DAA does not challenge conclusions drawn by DotEcon in relation to how the proposed restructuring of the former ART could affect the setting of charges at Dublin airport.

## 3.2 The regulatory basis for setting charges

DotEcon's analysis

A core element of the DotEcon Report was a consideration of the changes that might be required to the Commission's framework for setting airport charges in light of the restructuring of ART.[10]

Section 3 of the DotEcon Report lays out the various ways in which the restructuring of the former ART could affect the Commission's original regulatory framework. DotEcon noted that the timing provided for under the 2004 Act made it likely that the Commission would make a new determination on airport charges before any transfer of assets, debt or equity amongst the three airport companies.[11] DotEcon concluded that "it would seem appropriate for the Commission to set maximum charges for Dublin airport using the method by which it calculated the existing Dublin sub-cap".[12]

The DotEcon Report then set out what the impact of the restructuring would be in relation to the key elements underpinning the current Dublin sub-cap, namely:

- the RAB calculated for Dublin airport;
- the WACC of the former ART;
- depreciation of assets in the Dublin RAB;
- operating expenditure commensurate with the expected passenger volume handled at Dublin airport;
- the expected tax liability arising from operations at Dublin;

---

[10] This comprised Section 3 of the DotEcon Report.

[11] DotEcon's view is that this is because the Commission is obliged to complete its new determination no later than 12 months after the Dublin Appointed Day (i.e. it must be completed by 1st October 2005 at the latest), whereas the transfer of assets and liabilities to Cork Airport Authority and Shannon Airport Authority could only happen after April 2005. As a result, according to DotEcon, bearing in mind the legislative requirement of the Commission to make its new determination "as soon as is practicable", it is likely that the new determination will be made before the financial restructuring takes place.

[12] DotEcon Report, paragraph 49. See also the Decision of the Commission further a Referral to the Aviation Appeal Panel, CP2/2002 of 9th February 2002.

- gross commercial revenues earned from the provision of services at Dublin airport; and
- the expected passenger volume handled at Dublin airport.

DotEcon concluded that the only component that might be affected in any significant way arising from the restructuring was the WACC of the former ART (now DAA). DotEcon was of the view that the overall impact on the WACC was "unclear" and, hence, it was also unclear as to whether or not it should warrant any material modification to the existing price cap on Dublin Airport.

Dublin Airport Authority's Analysis

DAA's report similarly focused on the WACC. While DotEcon concluded that the impact would be unclear, DAA argued at length that the restructuring would have a material impact on the WACC and estimated that it could increase by 0.3 percentage points or more, other things being equal. The report highlighted a range of issues that would be relevant to the assessment of the WACC and analysed the regulatory precedents, notably in the UK.

The Commission's approach

The Commission recognises that Dublin Airport Authority's WACC is a material issue for a determination of airport charges and will re-examine the WACC taking into account the current and prospective financial position of DAA.

In general, the Commission expects to build on the framework established in the 2001 determination and subsequent reviews. The Commission acknowledges the importance of regulatory consistency but does not believe this means regulatory inflexibility. Reflecting the analysis of the two firms of consultants in particular, the Commission expects changes of emphasis rather than fundamental changes to its building block approach.

### 3.3 Issues relating to the Dublin Airport Authority's review of DotEcon's report

Set out below are several other points raised by Dublin Airport Authority.

3.3.1 Dublin Airport Authority's cost of capital and the price cap

DAA state that the DotEcon Report concludes that any increase in Dublin Airport Authority's cost of capital should not be included in DAA new price cap.[13] In fact, DotEcon stated that the impact on the WACC of DAA arising from the restructuring was "unclear" and "hence it is also unclear as to whether or not it should warrant any material modification to the existing price cap on Dublin Airport".[14] While DotEcon expressed its view that "there are good arguments to suggest that any significant increase in WACC of DAA over the current WACC of ART is likely to be the result of an inefficient restructuring decision and should therefore not form the basis for an increase in charges"[15], this was not one of the principal conclusions of its report.

DAA dwells in significant detail on its possible cost of capital arising from the restructuring. In doing so, it puts forward the view that "CAR's new statutory objective in relation to DAA's sustainability and financial viability would make it difficult to justify an approach to regulation that did not allow DAA to earn its actual cost of capital (rather than a lower cost of capital based an a hypothetical "optimal" financial structure)".[16]

The rejection by DAA of the idea of using an 'optimal' financial structure in order to determine the cost of capital of a regulated firm is contrary to the view given in a previous report by DAA when ART, which was submitted to the Commission in the context of the original price cap determination in 2001. At that time ART used 'optimal' gearing in the calculation of its WACC, without considering the question whether actual or optimal gearing should be

[13] This claim is first made in the Executive Summary of the NERA Report (page i) and then is repeated several times throughout the report.
[14] DotEcon Report, para 59.
[15] Ibid, para 66.
[16] NERA Report October 2004, Section 3.1.1.

used.[17] The Commission's position on this issue in the previous determination was to take into account the actual gearing of the company in deciding its cost of capital. The Commission proposes to re-examine this area, taking into account, for example, issues such as the equity risk premium of Dublin Airport Authority.

### 3.3.2 Competition and economic efficiency

DAA appears to believe that a dichotomy exists between competition and economic efficiency and assert "if there is a departure between the likely outcome of a notional competitive market and the likely result of an independent economic regulator seeking to promote economic efficiency, then DotEcon's brief clearly indicates that it should base its analysis on the latter".[18] It goes on to characterise DotEcon as "having adopted competition rather than economic efficiency as its benchmark".[19]

It is the Commissions view that DotEcon's argument was simply that competition is a means to achieving an efficient outcome and that, where competition is not present, regulation is another means to achieving economic efficiency. It is in this sense that regulation should seek to produce an efficient outcome, one that similarly would have been achieved by a well-functioning, competitive market. In this respect, the position put forward by DotEcon is not at odds with that set out by DAA.

### 3.3.3 Pricing and inefficient cost

DAA claims that "DotEcon appears to adopt a general view that inefficient costs should be excluded from the price cap altogether".[20] This would mean, accordingly, that for some or all of the price control period, the price cap would be set below the regulated firm's actual cost and so it would be unable to recover its cost of capital.

---

[17] See NERA, Aer Rianta's Cost of Capital, London 2001, submitted as Appendix 5 of the ART response to Commission for Aviation Regulation's consultation on the original price cap.
[18] NERA Report October 2004, Section 2.1.
[19] Ibid.
[20] Ibid.

DotEcon specifically acknowledged that inefficiently incurred costs could be factored in at the starting point for a price cap.[21] DotEcon noted that, where this happens, a regulator would then set a higher "X" [22] (in absolute terms) to ensure that the regulated firm's prices approached efficiently incurred costs over time.

The Commission's position on this issue in the previous determination was to take into account reasonably incurred costs and achievable future efficiency targets. The Commission does not propose to alter this approach.

### 3.3.4 The role of Government

The DAA devotes considerable attention in its report to the issue of whether or not it makes sense for a regulator such as the Commission to provide incentives to Government as the owner of a regulated firm.[23] It sets out its belief that the incentives that regulators might provide could (and, indeed, should) vary, depending on whether the regulated firm was in private hands or was state-owned. In the latter case, DAA states that the arguments for providing such incentives are far less clear than if the firm were privately owned, as the Government "should be expected to make rational decisions, based on criteria including economic efficiency".[24] It goes on to state that, to the extent that any Government decision results in a loss of economic efficiency, this is not because of profit-seeking behaviour but instead would be in pursuance of some other policy objective. According to DAA, it "is far from obvious that economic regulators should carry out their functions in a way which threatens to override, or is at least inconsistent with, wider Government policy".[25] It then concludes, that as "the provision of such incentives is one of DotEcon's main arguments for excluding the impact of a

---

[21] DotEcon Report, paragraph 26.
[22] When a price cap is set for a period of more than one year, it changes year to year to reflect efficiency targets and inflation. Therefore, the maximum level of airport charges formula incorporates a CPI-X figure. CPI is the percentage change in the Consumer Price Index year on year while X is a number that reflects the combined effect of all the key policy variables that enter into the calculation of the regulated entities allowed yield, in particular operating expenditure, capital expenditure and the traffic forecast. See Appendix 2 to the Determination in respect of Maximum Levels of Airport Charges, CP7/2001, 26th August 2001.
[23] NERA Report October 2004, Section 3.2.
[24] Ibid.
[25] Ibid.

higher WACC from DAA's new price cap, this further weakens the case for this particular recommendation".[26]

The Commission is a statutory body and government policy as to its role in the regulation of airports is set out in its primary legislation, the Aviation Regulation Act, 2001. Furthermore, should the Government wish the Commission to proceed to take into account additional matters outside its express statutory mandate, the primary legislation provides two mechanisms by which this can be achieved. Firstly, section 10 of the 2001 Act states that the Minister may give such general policy directions to the Commission as he or she considers appropriate to be followed by the Commission in the exercise of its functions. Secondly, section 33(2)(f) of the 2001 Act, as substituted, states that in making a determination the Commission shall have due regard to policy statements, published by or on behalf of the Government or a Minister of the Government and notified to the Commission by the Minister in relation to the economic and social development of the State.

DotEcon did argue, that if the financial restructuring results in a significant increase in DAA's costs, this would suggest that the restructuring itself was inefficient and that such inefficiency should not be rewarded by the regulator via increased airport charges[27]. As discussed earlier, however, the DotEcon Report did not set out any firm conclusions about the exclusion of an increase in DAA's WACC from the new price cap. Furthermore, DAA's discussion relates to both the Government's position as national policy-maker and its position as the sole shareholder of a regulated company. It submits the restructuring itself may be viewed as a policy decision but that decisions relating to capital structure are shareholder decisions. The Commission's view is that regulation should provide the same incentives to the Government

[26] Ibid.

[27] DotEcon Report, paragraph 88. DAA argue that an increase in Dublin Airport Authority's cost of capital does not imply that the restructuring decision was inefficient because such an increase could be outweighed by gains elsewhere. This does not invalidate DotEcon's conclusion that a <u>significant</u> increase in Dublin Airport Authority's cost of capital would suggest an inefficient restructuring decision. Moreover, if the increase in costs at Dublin were accompanied by greater cost savings elsewhere, which would benefit the owner of ART or DAA/CAA/SAA, allowing the higher cost to be recovered through higher charges at Dublin would produce windfall gains for the Government as a shareholder at the expense of users of Dublin airport.

as a shareholder of the regulated company as it would to any private shareholder.

In its response, DAA does not address the legislative mandate provided by the Oireachtas to the Commission to be "independent in the exercise of its functions".[28] There is therefore no reason why the Commission's position on matters relating to aviation regulation should at all times be at one with that of the Government, especially with regard to the Government's interest as the sole shareholder of the regulated company.[29] Moreover, there is no reason to view any such differences in the stark way submitted by DAA, for example, where it speaks about the possibility of "a potential damaging inconsistency between the views of CAR and the Government"[30]. The Minister retains the power to issue general policy directions to the Commission and to notify it of policy statements published by or on behalf of the Government or a Minister of Government in relation to the economic or social development of the State, to which the Commission is obliged to have due regard.[31]

[28] See section 6, Aviation Regulation Act, 2001.
[29] In this context, DAA do not advert to what has happened in practice in Ireland and, in particular, the often-fraught relationships that can exist between central Government and independent regulatory agencies. Possibly the clearest example of this is the year-long public stand off that occurred between the Department of Finance and the ODTR (now Commission for Telecommunication Regulation) over the terms for the 3G mobile licensing framework.
[30] NERA Report October 2004, Executive Summary, page ii.
[31] See sections 10 and 33(f) of the Aviation Regulation Act, 2001 as amended.

# 4. CONCLUSIONS

This paper examines how the State Airports Act, 2004 alters the manner in which the Commission for Aviation Regulation specifies maximum levels of airport charges pursuant to the Aviation Regulation Act, 2001. A significant change introduced by the Act is that it restricts the application of regulation to airport charges levied by DAA, a new entity, to Dublin Airport alone. In addition, the 2004 Act, amends the statutory obligations of the Commission for Aviation Regulation in making a determination. It does so by substituting into the Aviation Regulation Act, 2001, a new section 33 which relates to regulatory objectives in respect of airport charges and the factors to which the Commission shall have due regard when making a determination.

In interpreting these objectives the Commission equates:

1. productive efficiency with the reference in (a) to the efficient and economic operation of Dublin Airport;

2. dynamic efficiency with the reference in (a) to the efficient and economic development of Dublin Airport to meet the requirements of prospective users, the reference in (b) to protecting the reasonable interests of prospective users, and the reference in (c) to enabling an efficient operator of Dublin Airport to be able to operate and develop the airport in a sustainable and financially viable manner;

3. allocative efficiency with the reference in (a) to meeting the requirements of current users, and the reference in (b) to protecting the reasonable interests of current users.

The Commission concludes that the new explicit reference to the efficient and economic operation and development of Dublin Airport strengthens the basis for its view that the essence of its statutory mandate is to promote economic efficiency. In addition to strengthening the basis for its approach of promoting economic efficiency, objective (a) can also be seen as a replacement of the previous Section 33(b) of the 2001 Act, which required the Commission to have due regard to the regulated company earning a reasonable rate of return on capital employed. Providing for a reasonable rate of return encourages the entity providing the regulated services to make efficient decisions regarding the amount of capital to invest in the regulated activities.

Providing for the regulated firm to earn a reasonable rate of return on capital employed in the investment, thereby allowing the sustainable and financially viable operation of the airport is in the interest of users. This approach, which facilitates dynamic efficiency, best meets the newly framed statutory objective, having regard to the level of investments in line with safety requirements and commercial operations in order to meet current and particularly prospective needs of users. In this regard statutory objectives (a) and (b) are closely linked.

The Commission is of the view that it should attain its objective of enabling DAA to operate and develop Dublin Airport in a sustainable and financially viable manner while also providing incentives for DAA to operate and develop in an efficient manner and protecting the reasonable interests of users. The Commission is of the view that objective (c) requires the testing of the financial robustness of its regulatory proposals in the context of measuring the financial risks likely to face a regulated firm operating in a reasonably efficient manner.

The Commission is of the view that equal weight must be given to all three objectives and that one does not have precedence over the others.

The following are conclusions in relation to the various statutory factors:

Restructuring.

As the first determination pursuant to the new Act must be made by the 1st October 2005, the restructuring within the meaning of the 2004 Act cannot be taken into account pursuant to section 33(2)(a) unless Cork and Shannon

Airport Authorities are vested with the ownership and management of their respective airports within that time.

Level of investment

The Commission's view remains that as airports are capital-intensive businesses, it is necessary that their economic regulation be consistent with a level of investment in facilities that allows the needs of users to be met.

An assessment as to the required CAPEX programme and its efficiency is, therefore, a central element of the economic regulation of airports. Consequently, it is necessary that a regulated firm's investment plans be carefully scrutinised as to their timing and efficiency.

Some consensus or approval between DAA and the users of Dublin Airport as to the necessity of capital projects would benefit all parties and the Commission in making a determination.

Rate of return on capital employed

This former factor has been deleted from section 33 by the 2004 Act, but the Commission is of the view that it has been subsumed into statutory objective (a). The Commission is of the view that assessing a reasonable rate of return on capital employed remains necessary.

The efficient and effective use of all resources

The Commission notes that this section has been deleted by the 2004 Act but is of the view that this factor has been subsumed into statutory objective (a). It is the Commission's view that the requirements of current and prospective users equate with the notion of allocative efficiency. Addressing matters of cost competitiveness will facilitate the achievement by the airport of greater operational efficiency.

Contribution of the airport to the region

This section has been deleted from section 33 by the 2004 Act. It has not been replaced nor has it been transposed in identifiable form to another factor or objective. Therefore, the Commission is no longer required to have regard to this factor.

The level of income

The Commission's view is that it will continue to use a single till approach in assessing the appropriate level of income to be taken into account but may consider the use of the dual till in the future as this allows it to determine airport charges with respect to operational income, which refers to both airport charges and commercial revenues.

Furthermore, it is of the view that its policy of disregarding income having an insufficient nexus to the airport, e.g. Great Southern Hotels, should continue. In a new addition to the legislation, the Commission must have due regard to any income arising from the restructuring.

Costs or liabilities

The Commission notes that when making a determination on airport charges at Dublin Airport it must have regard to the costs and liabilities for which DAA is responsible. If costs incurred by the airport authority other than at the airport are incurred in furtherance of its duty to operate the airport, the Commission would expect to assess them alongside other costs in its calculations of permitted airport charges. However, if those costs are not attributable to DAA's airport operating activities, i.e. if there is insufficient nexus to the airport, the Commission must interpret its responsibility to have due regard to them in the light of its statutory objective to protect the reasonable interests of current and prospective users of Dublin Airport in relation to Dublin Airport. Provided sustainability and financial viability is not at issue, the Commission would expect to treat these costs in the same manner as those associated with other activities such as Great Southern

Hotels referred to in paragraph 2.3.6 above: marked down to zero in its determination of airport charges.

In line with regulatory practice, the Commission intends to roll forward the value of the Dublin airport business, its Regulatory Asset Base. Under this approach, the effect of a transfer of ART's debt to DAA should be to create a capital structure for the company, determining how much of the total capital is made up of debt and how much of equity. The implied level of equity would be the residual of the Regulatory Asset Base after taking account of the value of debt.

The Commission concludes that the transfer of debt to DAA has no direct bearing on the valuation of the Regulatory Asset Base but accepts that it may have an impact on the assessment of the reasonable rate of return.

Policy Statements

The Commission is of the view that it is only those policy statements that are specifically notified to the Commission by the Minister, which should be considered under this statutory factor.

Cost Competitiveness

The Commission believes that this factor, which has removed explicit mention of international practice and operational efficiency, must be read in the light of statutory objective (a), which seeks the efficient operation of Dublin Airport. The efficient operation of Dublin Airport is thus re-stated with greater, as opposed to less, emphasis by its inclusion in statutory objective (a).

The level and quality of services

The Act now applying to Dublin airport only, there is no direction to alter policy and the essence of this factor is a restatement. In the new determination, the Commission will attempt to define levels of service quality standards to be incorporated in the determination.

Minimum Restrictions

The Commission is of the view that there is no change in policy needed regarding this factor.

Obligations

The Commission considers that this provision is self-explanatory and proposes no change in policy.

Economic Viewpoints on the Restructuring

The Commission recognises that DAA's WACC is a material issue for a determination of airport charges and will re-examine the WACC taking into account the current and prospective financial position of DAA.

In general, the Commission expects to build on the framework established in the 2001 determination and subsequent reviews. The Commission acknowledges the importance of regulatory consistency but does not believe this means regulatory inflexibility. Reflecting the analysis of the two firms of consultants in particular, the Commission expects changes of emphasis rather than fundamental changes to its building block approach.

# 5. ANNEX I

LEGAL NOTICE

While the Commission for Aviation Regulation ("the Commission") at all times uses its best endeavours to ensure that all of the information on its website is up to date and accurate, the Commission accepts no responsibility in relation to and expressly excludes any warranty or representations as to the accuracy or completeness of the contents of its website.