Commission for Aviation Regulation Consultation Paper 1/2021

Consultation on a Second Interim Review due to COVID-19 of the 2019 Price Determination of Airport Charges at Dublin Airport

Question 5 - Views on DUB airport's Regulatory Model Strategic Proposals

IATA Submission - July 2021

IATA appreciates the opportunity to respond to the Commission for Aviation Regulation's consultation on views on Dublin airport's document on "Regulatory Model Strategic Proposals".

From the outset, we would like to point out that we believe that the current regulatory model works well and does not need any radical change. Clearly, COVID has posed challenges to the CAR on how to respond to the crisis, but to change a regulatory model on the basis of an highly extreme scenario which is unlikely to reoccur would be unwise and counterproductive.

Even more, CAR's combination of independence and clear statutory duties, has enabled it to take decisive action and make decisions that it considers most appropriate to the situation.

To be clear, the above doesn't mean that we agree with every single decision the CAR has made (which can be seen in our previous submission), but that we do not believe that a fundamental redesign of the economic regulatory model that the CAR has successfully been applying over the years is warranted.

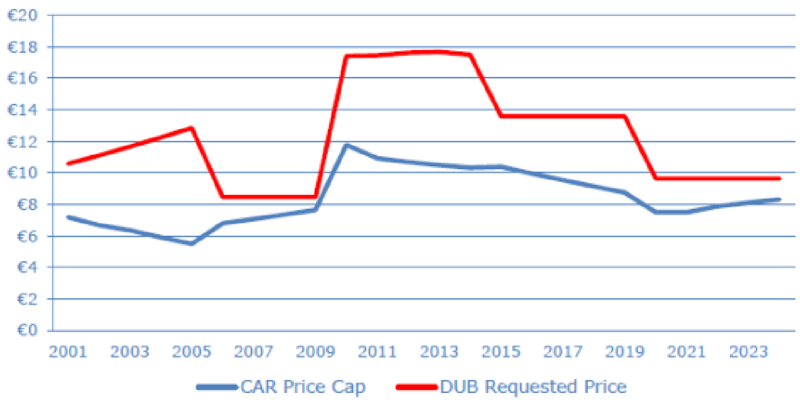
Having said this, we proceed with our analysis of DUB airport's proposals.

<u>Current and alternatives forms of regulation</u>

DUB airport argues that it is somehow special, that the application of incentive regulation through the implementation of price caps is not needed due to alleged market dynamics at the airport (relative to other airports subject to the same regime), and that a shift of economic oversight would lead to better outcome for users.

We contest such an assertion. The current economic model implemented by the CAR has brought significant benefits to consumers, which far outweigh the costs of implementing it. This can be seen in the chart (reproduced below) that the CAR provided in the 2019 determination which shows the difference between what DUB airport proposed and what was actually approved by the CAR:

Chat 3.3: Requested Price versus Price Cap



Source: CAR determinations

The regime applied at DUB has resulted in efficiency savings of hundreds of millions of euros that consumers have benefited from. One of the key reasons for achieving such a result is the level of scrutiny of the regulated entity by the regulator. An independent regulator with the appropriate duties, powers and resources would be able to achieve much more than users could achieve in a negotiated settlement in a non-level playing field; and airports know that.

We therefore see any attempt to move away from the current framework to light-handed regimes as a deliberate attempt to reduce such level of scrutiny. In none of the variants highlighted by DUB is the shadow price cap set with the level of scrutiny that is so much needed in an environment where there is asymmetry of information and power.

Furthermore, a monitoring regime would be even worse. While DUB airport indicates that the PC indicates that the price monitoring has created benefits consumers, the agency the actually carries out the monitoring, the Australian Competition and Consumer Commission, clearly disagrees: "*The current airport regulatory regime does not provide an effective constraint on* *the major airports' ability to exercise their market power"*[1]. We also do not see bilaterals as a way forward, since that opens the possibility for discrimination and a "divide and conquer" approach that could lead to poorer outcomes for consumers.

Instead of being a case for changing the current form of regulation, this is the time where it is the most needed. Once traffic starts to recover, this would clearly be the moment for airports to try to exert their dominant position and recover what they "lost" during the pandemic (or pass on the inefficiencies for not properly scaling operations down due to the traffic downturn). Without the safeguards of an effective regulatory regime, users could be facing significant increases in charges. This is already being seen at some airports.

Long term modifications of the regulatory building blocks

1) Risk sharing mechanisms

DUB airport is being remunerated for the risk it bears. Its allowed WACC compensates shareholders for frequent as well as one-in-one-hundred-year risks. In this regard, we see that any introduction of a risk sharing mechanism should be accompanied with a reduction in the WACC being allowed for DUB.

It should also be mentioned that there is a misconception as to the rationale for considering a risk sharing mechanism by the CAA at Heathrow. The need for a mechanism is not being considered to implement an automatic rule to deal with large variations in traffic that would be applied to the next and future price reviews. Right now, it is only being considered for the next few years (i.e. the potential large deviations when forecasting traffic during the years in which traffic is recovering from the pandemic).

With regards to the AdP and AdR examples, it should be noted that the traffic risk sharing mechanisms were not set by independent authorities, and therefore could have been influenced by other motives. Moreover, in the case of AdP the magnitude of the change of the price cap was very small, making it irrelevant in the context of what DUB wants to achieve. Finally, AdP rescinded the ERA, so this mechanism does not exist anymore.

[1] ACCC submission in response to the Issues Paper – Productivity Commission Inquiry into the Economics Regulation of Airports. September 2018

Cost assessment - Degree of flexibility of capital plan

The current regulatory framework provides a thorough opportunity for airlines to engage with the airport on the scope, timing, and amount of capex investment. While the process can be time consuming it does ensure that the needs of users are carefully considered, and that the resulting Capex plan is one that airlines can support and factor into their own plans.

The CAR recognizes that capex projects are subject to changes in the market environment and need to be aligned with the needs of current and future airport users. The establishment of the Stage Gate process and the requirement for consultation on the timing over certain Capex projects over €4m are examples of efforts to provide oversight and the flexibility to make changes to investment triggers or allowances that help ensure Capex remains relevant.

IATA recognizes that core Capex investments (maintenance, asset replacement/ safety/regulatory compliance) must get done and that the scope and costs tend to be more routine and predictable than capacity enhancement projects. IATA is open to discussing ideas to further increase flexibility in the capital planning process but for now sees merit for retaining core capital projects in consultation as it aids in providing a complete and transparent view of the total Capex programme and a better understanding of what airlines are paying for.

The regulatory till

IATA has already made aware to the CAR Its longstanding position that charges should be set on a Single till basis, as that would be the pricing mechanism used by an airport if it was in a real competitive environment. And this position has not changed at all due to COVID.

Key reasons why Single till should be applied:

- Single till is an acknowledgment of the symbiotic and essential business partner relationship between airports and airline users. The commercial activities within an airport only exist due to the passengers that airlines bring.

- Airlines transport passengers to the airport, invest significantly in airport infrastructure and as the primary users, should benefit from non-core activities.

- A dual till approach to charging is possible only because a company does not operate in a competitive environment. Economic regulation should strive for a single till approach that will enable lower charges, generating lower fares and increased traffic volumes, while delivering appropriate returns across the whole airport business.

- Airports are built specifically for aviation purposes and priority must be given to airline activity and passenger facilitation.

- Single till eliminates the need for difficult, detailed cost and asset allocation between aeronautical and commercial tills.

- Single till, in combination with the appropriate economic regulation, incentivizes and allows airports to increase retail and commercial revenues, while decreasing charges to airline users.

- There is no evidence that dual till provides better incentives for airports to make timely investments than single till. Dual till can incentivize airports to invest in potentially higher-return commercial activity to the detriment of essential aeronautical infrastructure.

Underlying Theory

1. In a competitive market, firms are assumed to price down to cost (including the cost of capital) to attract customers. A firm that sets its prices significantly above costs risks losing customers to rivals who could undercut its prices while still recovering costs.

2. An airport facing competition would be expected to set its aeronautical charges below the competition to attract traffic. To lower prices, the airport would take in consideration the costs of providing aeronautical services as well as the additional net profits that it would obtain on non-aeronautical services through attracting additional passenger volumes.

3. Under a dual till, airports that set their aeronautical charges to fully recover infrastructure costs will earn excessive profits overall. This is because the airport infrastructure generates both profits directly from airlines as well as profits from the retail and other activities of passengers. As airlines operate in a competitive market, increases in charges are not directly visible to passengers as airlines (who must operate as “single till” entities as they are in competition) will adapt their prices to retain their market position.

4. To illustrate that dual-till can only be a successful strategy in the presence of market power, consider that under competition, an airport that set aeronautical charges solely on the basis of the costs of providing aeronautical services would face losing airlines and

passengers to a rival airport that could offer lower charges while still recovering its overall costs through the profits available from its retail and other non-aeronautical services.

5. Therefore, switching from a dual or hybrid till to a single till would be likely to result in lower airport charges to the benefit of consumers. Further, as shown by the airports reporting under a single till, efficient levels of investment still take place. Single tills can be applied with adjustments to support airports making commercial investments where they will bear the risks by excluding the revenues and costs of those investments from the calculation of the price cap.

6. The attractiveness of commercial activities at airports is largely explained by the scale and density of passenger traffic, as well as the locational exclusivity of airside retail facilities. Neither of these factors are intrinsically driven by airport-related commercial decisions and are instead driven by demand characteristics of the travel market. The positive externalities produced by passenger demand need to be considered in the same way that negative environmental externalities are considered.

7. Accordingly, there is a clear interdependence between the level of airport charges and the scale of commercial revenues. When airport charges decrease this generates lower air fares and increases demand for air travel leading to more passengers using the airport. The higher number of passengers - all else remaining constant - will generate greater commercial revenues. Given this relationship, the charges should be set based on considering aeronautical and commercial activities. Therefore a "single till" is better suited for identifying the level of charges that would be efficient from a production perspective.

Dual till and privatisation

It should be noted that the prominent examples of airports shifting to dual till (AENA, BRU, Rome), all have one thing in common: Governments seeking to maximize income from privatization by changing charging mechanism. For example, the shift from Single to Dual till at Brussels is included in the "Privatisation decree" of the airport. AENA's shift to dual till was determined shortly before the State sold 49% of its shares. And Rome is a concession, and a dual till allows it to pay high initial and variable concession fees. None of these processes had the passenger in mind.

Users worse off from hybrid till

We do not see the benefits that are being claimed in the paper for moving to hybrid till. For instance,

- One of the arguments is that profits from commercial activities <u>may</u> be reinvested in airport infrastructure reducing airports capital needs. However, in a single till they <u>will</u> be used to reduce the pressure on charges, so we don't see any benefit.

- The pandemic has clearly demonstrated that passengers are essential to the development of commercial activities. Again, no justification for moving away from a Single till approach.
- We do not think that the financial viability of the airports would improve significantly, since hybrid/dual till approaches would allow situations in which shareholders would simply distribute a higher level of dividends due to the excess profits made in the commercial activities; leaving the company with the same capital structure and users paying a higher level of charges than what they would need to.

Overall, we see no reason to deviate from the application of the Single Till at DUB airport.

<u>Price cap compliance</u>

We understand the difficulty in forecasting cargo revenue but do not see the reason as to why cargo revenue should be removed from the price cap. On the contrary, such removal could cause some perverse incentives to modify its charges structure to game such a system.

For instance, let's assume that cargo revenue was not considered in the cap. Let's also assume that DUB airport decided to "rebalance" from passenger service charges to landing charges. While revenue neutrality could be maintained among the activities within the cap, the shift would automatically imply that DUB would be receiving an overall higher level of revenue (since cargo flights would be paying the higher landing charge and cargo is outside the cap in this example). This is something that we have recently seen in the case of Heathrow; an effect that had been compounded by during COVID times since the cargo share has been much higher than usual. Such situation should not be allowed by a regulator.

We agree that using a WLU approach is also difficult due to the limited cost rationale between 1 passenger and 100kg of cargo. Hence, we recommend sticking to the current practice.

Price control duration

We could understand that the potential implementation of longer regulatory periods at industries where demand is stable and predictable like in the case of water, but not in the case of aviation. The longer the period, the bigger the deviation between costs and revenues and the lower the opportunity to adapt to changing circumstances. While users do value tariff certainty, this should not come at any cost. Moreover, there is a need for a price reset to pass on benefits to consumers from outperformance, as highlighted in the next paragraph.

We understand DUB airport's point on the need to incentivize efficiencies, but we consider a 5-year period already provides sufficient time to generate such incentives. There needs to be a balance between how long the regulated entity can keep outperformance before it is passed on to users via a new price control (which is the entire point of incentive regulation).

There is another argument for the usage of a longer period, particularly in the traffic recovery period after COVID (which could cause upwards pressure on charge). However, a longer period is not the only way to address this. There are other mechanisms, such as regulatory depreciation, that could be used to mitigate such short-term pressures. In previous decisions the CAR decided to bring forward regulatory depreciation to smooth reductions in charges, in the next period it may need to push it back.

Regulated entity recapitalization

DUB airport was allowed a cost of capital in line with the risks it was bearing; and this included the traffic risk. DUB has benefited from holding this risk in the past (e.g. the significant traffic outperformance registered in the 2014-18 period) but now it is reneging on its obligations in this regulatory contract on an ex-post basis and seeking a RAB adjustment to recover its loses. The airport cannot have it both ways. If DUB airport wished to move to a rate of return system, then its WACC should be closer or at the rate of Government bonds and not the WACC it was allowed. Moreover, such debate should be held before a decision on a regulatory period, not on an ex-post basis.

There is also no guarantee that a regulated entity should recover its regulatory depreciation. This was also examined by the CAA in HAL's request for a RAB adjustment: "*The Q6 price control for HAL was set on the basis that HAL would recover regulatory depreciation and a reasonable allowed return on a forward looking basis, and that it would also bear traffic risks. This does not constitute a guarantee that HAL would recover regulatory depreciation irrespective of what happens to traffic levels during the regulatory period*"[2]

We note that the CAA did allow for a RAB adjustment of GBP 300m (vs. the GBP 2.6bn requested by HAL). However, this was not based on any compensation of loses or traffic or depreciation, or anything like it. It was based on the assumption that HAL would reach a level of gearing (from an efficient company point of view) that could have triggered a change in the credit rating of the company (gearing >70%) that would have increase the cost of debt in a way that was detrimental to consumers. The CAA adjustment is meant to lower such gearing before that triggering point[3]. Such adjustment implies that it could be removed in the future should the efficient company did not need it in the future.

There is also a claim from DUB airport that it will not be able to raise debt to finance its investments. So far the evidence does not show that DUB, or airports of its size, are having issues in raising debt. While airports have had downgrades in 2020 (see table below), these have been minimal and have not gone down any further, which show the overall positive view from the markets towards airports.

Airport	From	To (2020)	Notches Rating	Notches SACP*
Flughafen Zurich AG	AA-/Stable	A+/Negative	-1	-1
NATS (EnRoute) PLC	A+/Negative	A+/Negative	0	-1
Aeroports de Paris S.A.	A+/Stable	A/Negative/A-1	-1	-2
Royal Schiphol Group B.V.	A+/Stable/A-1	A/Negative/A-1	-1	-2
Avinor AS	AA-/Stable/A-1	A/Negative/A-1	-2	-2
Daa PLC	A/Stable/A-1	A-/Negative/A-2	-1	-1

[2] CAA, CAP 2140, Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment, page 14

[3] For avoidance of doubt, we believe that no RAB adjustment should have been allowed, and that any gearing increase should have been addressed via equity injections.

Heathrow Funding Ltd.	Class A: A-/Negative Class B: BBB/Negative	Class A: BBB+/Negative Class B: BBB-/Negative	-1	-1
Gatwick Funding Ltd.	Class A: BBB+/Negative	Class A: BBB/Negative	-1	-1
Aeroporti di Roma SpA**	BB+/Watch Neg/B	BB+/Developing/B	0	-2

Source: S&P March 2021

**** AdR was upgraded to BBB- in June 2021**

Moreover, we note from DDA's 2020 financial accounts that it was able to raise an important amount of debt, it spent some EUR 278m in capex, and even still, its average cost of debt in 2020 was lower than that in 2019 (1.7% vs. 2.2%).

Finally, we note that the CAR decided not to clawback allowances (depreciation & Cost of capital) on unspent capital expenditure during 2020 and 2021. In our opinion it wasn't the right decision, as that would imply that a potential double counting of depreciation & cost of capital in the next regulatory period (and mixing traffic risk with capex). We understand that this decision is being reviewed by the Appeal Panel. Should the CAR decision be upheld, not to clawback such inexistent expenditures would constitute an additional reason (on top of what was above mentioned arguments) on why there shouldn't be any RAB adjustment, as the airport is already benefiting from this decision.

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