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**AR/CAR/01-02**

**Aer Rianta Response  
To Commission Paper  
CP1/2002**

January 2002

***AerRianta***

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## Introduction

1. On the 10th January, 2002, the Aviation Appeal Panel established pursuant to section 40 of the Aviation Regulation Act, 2001 (“the 2001 Act”) published its decision on the appeals brought by a number of parties from the Determination of the Commission for Aviation Regulation of the 26<sup>th</sup> August, 2001.<sup>1</sup>
2. For the reasons set out in its detailed written Decision, the Panel considered that, in respect of a number of the issues raised in the appeals, there were “sufficient grounds” for referring the decision in relation to the Determination back to the Commission for review pursuant to section 40(5) of the 2001 Act.
3. On the 16<sup>th</sup> January, 2002, the Commission published Commission Paper CP1/2002, *Notice of the Commission relating to the Decision of the Appeal Panel*. This Paper invited interested parties to make submissions to the Commission in relation to the matters referred back to it by the Appeal Panel. Aer Rianta makes this submission to the Commission on foot of that invitation.
4. As the Commission is aware, Aer Rianta has instituted judicial review proceedings against the Commission in which it seeks to have the Commission’s Determination of the 26<sup>th</sup> August, 2001 set aside. These submissions are made to the Commission strictly without prejudice to Aer Rianta’s contention that the Determination of the 26<sup>th</sup> August is invalid and ought to be set aside.

## The Matters Referred Back to the Commission for Review

5. Section 3 of CP1/2002 identifies 10 matters referred back to the Commission by the Appeal Panel as follows:
  - Off-peak Landing and Take-off charges and aircraft classification
  - Efficiency
  - OPEX
  - Depreciation
  - Transfer and Transit passengers
  - Cargo charges
  - Security surcharges
  - Passenger numbers/forecasts
  - Interest payments
  - Communications from Commission
6. The last of these items, “Communication from the Commission”, arises from a letter of the 20<sup>th</sup> December, 2001 from the Commission’s solicitors to the Appeal Panel

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<sup>1</sup> Appeals were brought by the parties referred to in paragraph 3.02 of the Appeal Panel’s Decision. Aer Rianta did not appeal to the Appeal Panel but did make observations to the Appeal Panel in relation to the appeals.

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which acknowledged that the Commission had made a number of “errors or miscalculations” in the Determination. In particular, that letter acknowledged that “certain computational errors” had been made in relation to RAB/CAPEX”. Aer Rianta, through its solicitors, requested details of these “computational errors” but that request was ignored by the Commission. A copy of that letter is included in Appendix 1. While certain further information was set out in Annex II to CP1/2002, Aer Rianta remains unaware of the precise nature of the errors apparently identified by the Commission and of how those errors arose. Following the publication of CP1/2002, Aer Rianta, through its solicitors, urgently sought further information from the Commission in this regard and also sought an explanation from the Commission as to the nature and purpose of the consultation process it was proposing in respect of these matters. A copy of this letter is also included in Appendix 1. No response to that letter has yet been received from the Commission. In the circumstances, Aer Rianta is not in a position to determine whether it is appropriate to make any submissions to the Commission in relation to the item referred to in CP1/2002 as “Communication from the Commission” but reserves its right to make such submissions in the light of any response it may receive from the Commission.

7. These submissions will therefore address the first 9 items referred to in Section 3 of CP1/2002. As the Commission will be aware, Aer Rianta has already made detailed submissions to the Commission on many of these items prior to the making of its Determination of the 26<sup>th</sup> August, 2002. Rather than repeating what is stated in those earlier submissions, Aer Rianta asks the Commission to have regard to them. The attention of the Commission is also drawn to the document entitled “Observations on Submissions to the Aviation Appeal Panel” which Aer Rianta furnished to the Appeal Panel and which sets out its position on the issues raised in the appeals. For ease of reference, a copy of this document is attached as Appendix 2 and forms part of these submissions.

## The Status of the Decision of the Appeal Panel

8. Before addressing the items under review by the Commission, it is important to set out clearly the status of the Decision of the Appeal Panel. The statutory function of the Panel was simply to decide whether there were “sufficient grounds” for referring the Determination back to the Commission for review. For the reasons set out in its Decision, the Panel considered that there were “sufficient grounds” in respect of the matters identified in the Decision. That was the only determination made by the Appeal Panel. The Panel did not, and could not, direct the Commission to revise its Determination in any particular manner or at all.

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# Off Peak Take Off and Landing and Categorisation of Aircraft

## Aircraft Categorisation

9. The Appeal Panel identified a number of problems with the ACN-based classification which the Commission adopted in its Determination. Aer Rianta has never advocated the use of an ACN-based classification and considers that Maximum Take-Off Weight (MTOW) is a more appropriate basis for determining landing and take-off charges. As pointed out by the Appeal Panel, MTOW is the basis used by other airport operators for this purpose and its use avoids the difficulties of aircraft categorisation identified by the Appeal Panel. Accordingly, Aer Rianta favours the variation of the Determination in this regard, subject to such variation being effected in a manner which has a neutral effect on the overall level of airport charges.

10. Aer Rianta notes that the Commission, through its solicitors, suggested to the Appeal Panel that Aer Rianta was responsible for the incompleteness of the aircraft categories adopted by it in its Determination. That suggestion is wholly mistaken. As is clear from the letter of the 3<sup>rd</sup> January, 2002 from Aer Rianta's solicitors to the solicitors acting for the Commission (included in Appendix 1), Aer Rianta furnished all the information which was requested by the Commission and the Commission had details of all aircraft types which would have allowed it to prepare a complete aircraft categorization schedule.

## Off-Peak Take Off and Landing

11. No issue relating to the definition of "off-peak" and "peak" adopted by the Commission for the purposes of its Determination has been referred back by the Appeal Panel for review. Accordingly, it is not appropriate to address this subject in these submissions.

## Efficiency

12. In its Determination, the Commission applied an annual efficiency factor of 3.5% to operating expenditure at Dublin Airport and a 4% efficiency factor in the case of operating expenditure at Shannon Airport for the regulatory period. These values were largely based on the findings of a benchmarking exercise undertaken on behalf of the Commission by the consultancy firm IMG that concluded that operational expenditure exceeded the average of the "best of peers" by 29% at Dublin Airport and exceeded the "average of peers" by 50% at Shannon Airport. Cork Airport was deemed to be operating at the efficiency frontier.

13. In its Decision, the Appeal Panel expressed the view that the Commission should consider setting more demanding efficiency improvement targets for all three Aer Rianta airports in the light of (i) the need to reduce relative efficiency levels with

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peer airports more rapidly and (ii) economies of scale and technical improvements that should arise as the airports expand and develop.<sup>2</sup>

14. Aer Rianta believes that the efficiency targets set by the Commission are extremely demanding as they stand and unfair to Aer Rianta and there is no basis for revising them upwards and that, to the extent that the Appeal Panel took a contrary view, that view was and is mistaken. The factors identified by the Appeal Panel as requiring these efficiency targets will now be addressed.

“ The need to reduce relative efficiency levels with peer airports more rapidly”

15. The view apparently held by the Appeal Panel that relative efficiency levels needed to be reduced “more rapidly” clearly derives from the IMG Benchmarking Report and the “efficiency gaps” purportedly identified by IMG. While the Appeal Panel referred to the criticisms made by Aer Rianta of the benchmarking exercise carried out by IMG, it is apparent from its Decision that it considered itself precluded from considering these criticisms by virtue of the fact that Aer Rianta was not an appellant and that the appellants accepted the findings in the IMG Report.<sup>3</sup> The Decision of the Appeal Panel cannot, therefore, be construed as an indorsement of the IMG Benchmarking Report, the validity of which it simply assumed for the purposes of the appeals made to it.

16. The matter having been referred back to it by the Appeal Panel for review, it is incumbent on the Commission to have regard to the criticisms which Aer Rianta makes of the IMG Benchmarking Report. In this context, Aer Rianta adopts and repeats that part of its Observations to the Appeal Panel which addresses this issue.<sup>4</sup> In addition, Aer Rianta has carried out a detailed analysis of the IMG Report which is contained in Appendix 3 to this submissions.

17. For the reasons set out in these documents, Aer Rianta believes that the findings of IMG in relation to benchmarking are not reliable and do not provide an appropriate basis for imposing more exacting efficiency targets on Aer Rianta. The submissions to the contrary made by Aer Lingus and Ryanair are premised on purported “efficiency gaps” identified by IMG that do not exist in fact and should therefore be rejected.

18. Furthermore, as the Appeal Panel itself acknowledged, there is an element of subjective judgment involved in fixing efficiency targets.<sup>5</sup> Aer Rianta believes that the Commission was, and is, in a better position than the Appeal Panel was to exercise this judgment and that there is no basis for revising upwards the efficiency targets fixed by the Commission in its original Determination.

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<sup>2</sup> Paragraph 8.02(f) at page 18 of the Appeal Panel’s Decision.

<sup>3</sup> Paragraph 8.02(b) at page 16 of the Appeal Panel’s Decision. In fact, one of the appellant airlines, bmi, expressed “caution” about benchmarking other airports in its oral presentation to the Appeal Panel on the 10<sup>th</sup> December, 2001: see page 18 of the transcript of that hearing.

<sup>4</sup> Section 1.1 at pages 9-12.

<sup>5</sup> Paragraph 8.02(e) at page 17 of the Appeal Panel’s Decision.

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## “Economies of Scale and Technical Efficiencies”

19. The submissions made to the Aviation Appeal Panel argued for further increases in the efficiency targets set for Aer Rianta to account for possible economies of scale and technical efficiencies over the regulatory period. However there is no evidence to indicate that Aer Rianta will be able to derive gains from economies of scale and greater technical efficiency over the regulatory period.

20. In fact, it has been suggested that airports have a tendency to experience **diseconomies** of scale where the rate of growth in average cost proportionally exceeds the rate of traffic growth beyond a moderate level of traffic output. This view was put forward by one of the Commission’s own advisers, the economist David Starkie<sup>6</sup>, and his analysis suggests the level at which economies of scale can be assumed may have already been exceeded at Dublin Airport.

21. Diseconomies of scale (or rising marginal costs) are also more likely to occur in cases where airports are operating at or near capacity and need to invest in additional facilities to meet demand. This describes the current situation at Dublin. Cork Airport is capacity constrained at present (a fact previously acknowledged by the Commission<sup>7</sup>) and additional facilities are being invested in there.

22. Having regard to the demonstrated efficiency of Cork Airport, Aer Rianta submits that it would be wholly inappropriate to impose an efficiency target for it. This is particularly so when Aer Rianta is about to undertake substantial investment in capacity to address traffic growth requirements at Cork.

23. In addition to the arguments set out above, the Aer Rianta adopts and repeats that part of its Observations to the Appeal Panel which addresses this issue.<sup>8</sup>

## Operating Expenditure (OPEX)

24. The issue which has been referred back to the Commission by the Appeal Panel “refers to a lack of transparency in the figures presented by the Commission on the opening level of allowed OPEX.”<sup>9</sup>

25. As Aer Rianta has made clear in its judicial review proceedings against the Commissioner, it too has serious difficulty in understanding (*inter alia*) how the Commission calculated the opening OPEX value. Aer Rianta does not know how the opening OPEX value was calculated.

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<sup>6</sup> Starkie, D., A New Deal for Airports, IEA, Regulation Lectures, November 1999.

<sup>7</sup> CP8/2002, Appendix 8

<sup>8</sup> Section 1.2 (Economies of Scale) and 1.3 (Technical efficiency) at pages 13 -16 and 16 - 17 respectively.

<sup>9</sup> Paragraph 8.05(a) of the Appeal Panel’s Decision.

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## Depreciation

26. The Appeal Panel appears to have accepted the argument of Aer Lingus to the effect that the method of depreciation applied by the Commission may allow for accelerated depreciation of certain of Aer Rianta's and has referred this issue back to the Commission for review.

27. In the judicial review proceedings brought against the Commission, Aer Rianta has identified a number of errors which it believes were made by the Commission in relation to depreciation. Aer Rianta does not consider it appropriate, however, to address these errors in these submissions. As the Commission is aware Aer Rianta has an issue that it is unclear as to whether the depreciation policy in the Determination applies to land.

28. Without prejudice to the foregoing, Aer Rianta does not accept that, as Aer Lingus has suggested, the Commission allowed depreciation in the first year of the regulatory period which is significantly more generous than its assumed average lives would imply. Aer Lingus suggests that the depreciation charge in 2001/2002 should be £30.4m (£457m opening RAB divided by 15 years) as opposed to £35.3m as stated by the Commission. This calculation is erroneous as it fails to take into account depreciation on any Capex during the period. By simply dividing the assets in existence by the 15-year useful life Aer Lingus fails to recognize that:

- the depreciation charge for the period needs to cover not only depreciation on assets in existence at the beginning of the period but also depreciation on any capex during the period;
- the depreciation charge in the accounts does not include a full year depreciation charge for assets acquired during 2000;
- the figure of £457m is based on the indexed historic value of the assets and any depreciation calculation based on this figure is not comparable with the figure in the statutory accounts which is based on historic cost.

Aer Lingus refer to an estimate of cumulative depreciation over the period of IR£225m and an investment program of IR240m. However, Aer Rianta is not aware of how these figures are derived.

29. Furthermore, Aer Lingus argues that the Commission has given Aer Rianta an accelerated depreciation regime. Aer Rianta rejects this argument. In relation to capital expenditure Aer Rianta does not accept that the treatment adopted by the Commission conveys any material advantage as the depreciation charge on the capital expenditure based on Aer Rianta's useful lives is not significantly different from that based on the Commission's useful lives.

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## Transfer and Transit Passengers

30. In its decision, the Appeal Panel suggests that transfer and transit passengers should be separately identified in the overall passenger forecasts to avoid any ambiguity in interpretation. The Appeal Panel appears to have been under the impression that such data would be readily available. In fact, however, it would be very difficult to generate any meaningful or reliable data in this regard.

31. Transfer passengers comprise a small proportion of total traffic at the Irish airports. Such traffic is more volatile in nature than origin and destination traffic and even the airlines themselves often do not have complete information on transfer movements: each would only know its own traffic. For Aer Rianta to produce a forecast to any acceptable degree of confidence for the transfer segment would require the production by the airlines of a comprehensive historic time series of data for a ten-year period. Traditionally the airlines have been unwilling to provide this information. Furthermore, even if such forecasts were to be produced, the number of assumptions and hypotheses which would have to be built into the formulas would mean that the resulting figures would be of very limited value.

32. Similarly, transit traffic also forms a small proportion of overall traffic at the three airports. This traffic is often very price sensitive and highly competitive. Thus it is of an extremely volatile nature and is subject to radical change from season to season. It would not be possible to generate meaningful forecasts of this traffic.

## Cargo Charges

33. Aer Rianta has no further submissions to make on this issue.

## Security Surcharges

34. Aer Rianta has difficulty in understanding what issue is thought to arise in relation to security surcharges or the basis on which the Appeal Panel considered that there was any uncertainty in this regard. Aer Rianta accepts that the Commission's Determination prevents Aer Rianta from passing through additional security charges. In fact, the Commission's failure to provide a mechanism for passing these additional costs onto airport users is one of the grounds on which Aer Rianta relies in seeking to have that Determination set aside.

35. Aer Rianta does not accept that it has any responsibility for the operation of Hold Baggage Screening (HBS). Aer Rianta's position in this regard is fully set out in its Observations to the Appeal Panel. Insofar as there may any dispute in relation to that issue, it is not a matter for the Commission to determine. In any event, Aer Rianta has not sought to pass on to airlines the costs of operating HBS and accepts that it could

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not do so under the Determination as it now stands, without prejudice to its contention that the Determination is fundamentally flawed in this respect.

## Passenger Numbers/Forecasts

36. In the letter of the 20<sup>th</sup> December, 2001 written to the Appeal Panel on its behalf, the Commission acknowledged that it had used the wrong figures in respect of passenger numbers.

37. It appears from that letter that the Commission intended to use Aer Rianta's Centreline traffic forecasts. Aer Rianta provided these forecasts as part of its response to the first statutory request for information made by the Commission on the on 23rd March 2001. The Aer Rianta forecasts incorporate a centreline forecast with both high growth and low growth scenarios, all of which were previously presented to and discussed with the airline users at the airports. The forecasts pre-date the impact of Foot and Mouth Disease, the decline in the world economy and, most significantly, the impact of September 11th on traffic numbers at the airports.

38. In its Decision, the Appeal Panel suggested that the events of September 11<sup>th</sup>:

"may give rise to a revision of the centreline forecasts for passenger traffic by Aer Rianta which could now be taken into account by the Commission in generating revised maximum charges per passenger"<sup>10</sup>

In light of the events which have occurred since these forecasts were provided to the Commission and, in particular, the events of the 11<sup>th</sup> September which, of course, post-date its original Determination, Aer Rianta believes that it would be wholly inappropriate for the Commission to use those traffic forecasts without revision.

39. Aer Rianta sets out below the actual passenger numbers for 2001 and the current forecast numbers for 2002. The derived passenger numbers for the first regulatory year 2001/02 are also presented. The forecast numbers have been prepared on the basis of a detailed analysis of the aviation industry in Ireland and, in particular, on up to date information of airline capacity, market conditions and all other relevant matters.

	Dublin	Shannon	Cork	Total
Actual 2001	14.3	2.4	1.8	18.5
Revised Forecast 2002	14.3	2.1	1.8	18.2
Regulatory Year 01/02	14.3	2.1	1.7	18.1

40. Aer Rianta believes that the Commission should use the revised figures for 2001 and 2002 as the basis for the revised passenger numbers in the regulatory model for the regulatory year 2001/02. Current market conditions are very uncertain and it would be highly inappropriate for the Commission to adopt any forecasts above the

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<sup>10</sup> Paragraph 8.16(e) at pages 43-44 of the Appeal Panel's Decision.

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low growth scenario presented to it as part of Aer Rianta's forecasts on 23<sup>rd</sup> March 2001. Indeed, the low growth figure may even be too high in light of the current market conditions.

41. In this context recent views from industry sources regarding growth in the aviation sector are as follows:

- *JP Morgan, Industry Analysis European Airports, October 2001.*
  - Worst case scenario: traffic falls by 20% for 12 months to September 2002, with modest growth but no rebound thereafter. Traffic only regains 2000 levels in 2006.
  - Low traffic scenario: based on traffic falling for 2001 and 2002 but regaining 2000 levels in 2003.
- *Schroder Salomon Smith Barney, European Airline Review, October 2001.* 10% fall in passenger traffic expected over next twelve months - twice as bad as the fall after the Gulf War. Traffic is expected to recover in the long run but only from third quarter 2002.
- *Moody's, Growth in the Aftermath of Sep. 11th, December 2001.* Passenger traffic remains depressed with the general consensus being that 2002 numbers will see an average reduction of 15-20% in most markets
- *UBS Warburg (2001) Airports Review 2001, London, UBS Warburg Oct.* Indicates a 10% decline for the first nine months of 2002. In the subsequent year, they assume traffic will recover to the level before Sept 11<sup>th</sup> 2001.

## Interest Payments

42. The Appeal Panel has referred back the issue of interest payments on the basis of a perceived "anomaly" between the mechanism for recovery of under-charging (which includes provision for interest) and the mechanism recovery of over-charging (which does not).

43. Aer Rianta acknowledges that these recovery mechanisms are asymmetrical but does not accept that there is any "anomaly" as suggested. As the Appeal Panel itself acknowledged:

"recovery of under-charging is spread over the following regulatory year (which favours the users) while the repayment of over-charging is made in a lump-sum close to the end of the regulatory year in which it occurs (thereby impacting more adversely on the cash-flow of the airport operator)." <sup>11</sup>

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<sup>11</sup> Paragraph 8.17(c) at page 44 of the Appeal Panel's Decision.

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44. In view of the fact that Aer Rianta can only recoup the under-recovered revenues over the twelve-month period of the following regulatory year, there is no injustice in allowing Aer Rianta to recoup interest on under-recovery. In contrast, the airlines will receive a lump sum payment in respect of any over recovery within a very short time-span, so interest is not appropriate. There is therefore no basis for altering the Commission's Determination in this respect, particularly in view of the fact, again acknowledged by the Appeal Panel, that the financial import of the "anomaly" identified by it is marginal.

45. If the Commission is persuaded to alter its Determination to achieve the "consistency" referred to by the Appeal Panel, it should also review and revise the time-period in which over and under payments are recovered, so as to ensure that they too are consistent.

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## APPENDICES

1. Arthur Cox letters of the 3<sup>rd</sup> January, 2002 and the 22<sup>nd</sup> January, 2002.
2. Aer Rianta Observations to Aviation Appeal Panel part of Appeal.
3. Analysis of IMG Benchmarking Findings