Maximum Levels of Airport Charges in respect of Dublin Airport

Draft Determination and Explanatory Memorandum

Commission Paper CP2/2005

31 May 2005

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1. FOREWORD

Since the launch of its initial consultation process by way of a Public Meeting held on 1 October 2004 at the Great Southern Hotel, Dublin Airport and the publication of a number of both Commission and Consultant's papers[1] on the same date, the Commission for Aviation Regulation (the "Commission") has devoted much of its attention and resources to gathering and analysing a very substantial amount of data and information in order to carry out its amended statutory remit on airport charges under the Aviation Regulation Act 2001 ("the 2001 Act") as amended by the State Airports Act, 2004 ("the 2004 Act"). That process has culminated in the preparation of this Draft Determination and Explanatory Memorandum in respect of maximum levels of airport charges that may be levied by Dublin Airport Authority ("DAA") at Dublin Airport.

In accordance with the requirements of section 32 (7) of the 2001 Act, the Commission now provides, by way of publication of this Draft Determination and accompanying Memorandum, formal notice of its intention to make an airport charges determination and thereby commence the period of statutory consultation as provided for in Section 32 (7).

Since October 2004, the Commission has retained outside expertise in a number of critical areas of analysis and data gathering to assist it in making the new Determination. The reports and findings arising from this analysis are being published as part of this consultation process.

The Commission has been greatly assisted by the level of engagement by users and interested parties with the Commission's consultants. The

[1] CP6/2004; CP7/2004; a paper on Restructuring and Regulation by consultants, DotEcon Ltd.; and an outline of Capacity Assessment Methodology by consultants, William Hynes & Associates Limited.

Commission acknowledges the efforts of the many contributors to its work, and looks forward to their continued involvement in the consultation process.

As advised in CP6/2004, the primary purpose of publishing a draft determination is to allow interested parties to ascertain in general terms at an early stage, the impact or effect of the proposed levels of maximum airport charges. A further purpose is to inform interested parties of the Commission's approach to achieving its statutory objectives whilst taking into account each of the statutory factors. Section 4 sets out indicative levels of airport charges, which are in turn explained in Section 5. By way of further assistance to interested parties and the public, the Commission has also published, in Sections 7 and 8, details of significant figures and other inputs relied upon by the Commission in calculating the indicative maximum levels of airport charges.

The attention of interested parties is drawn to Annex I which sets out the strict conditions that apply to the receipt of statutory representations.

The indicative maximum levels of airport charges contained herein are preliminary in nature, and based, inter alia, on the information that the Commission has received to date. The Commission has made no final conclusions, and will not do so until it has considered any and all representations that it receives, and has decided either to accept or reject them.

William Prasifka
Commissioner

31 May 2005.

2. NOTICE OF THE MAKING OF A DETERMINATION

In accordance with section 32 (7) of the 2001 Act, the Commission for Aviation Regulation hereby gives notice of its intention to make a determination specifying the maximum levels of airport charges that may be levied by DAA in respect of Dublin Airport pursuant to section 32(2) of the 2001 Act, as amended by section 22 of the State Airports Act, 2004.

Pursuant to Section 32(7) of the 2001 Act, the Commission must allow a period, not being less than one month from the date of publication of notice of its intention to make a determination, within which interested parties or the public may make representations in respect of the Draft Determination. The closing date for the receipt of representations is **5.00 pm. on the 1 July 2005**. Interested parties should note the contents of Annex 1 concerning this deadline. The conditions contained therein will be strictly applied without exception. Interested parties should also note the guidelines regarding issues such as delivery of documents and confidentiality.

3. INTRODUCTION

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

In accordance with the provisions of the 2001 Act, the Commission was required to make a determination specifying the maximum levels of airport charges that may be levied at the three State airports, Dublin, Cork and Shannon. In making a determination, the Commission's objective, as set out in the 2001 Act, 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 also required the Commission to have due regard to ten specified factors. These were termed the "statutory factors" by the Commission.

The 2004 Act amended the 2001 Act in a number of respects. The primary amendments relate 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"[2] to make a new determination specifying the maximum levels of airport charges that may be levied at Dublin Airport. This new determination will super-cede the current Determination that was made by the Commission in August 2001, revised on Appeal in February 2002 and reviewed in March 2004.

The 2004 Act amended the statutory objectives of the Commission in making a (new) Determination. In particular, section 22(4) of the 2004 Act substitutes a new section 33 into the 2001 Act, which sets out the statutory objectives of the Commission and the statutory factors to which it must have

[2] The Dublin appointed day was the 1st October 2004.

due regard when making a determination on airport charges. The 2004 Act also restricts the scope of the 2001 Act. The Commission must now make a determination specifying the maximum levels of airport charges that may be levied by DAA in respect of Dublin Airport only. Cork and Shannon airports have therefore been removed from the remit of the Commission regarding airport charges.

3.1 Consultation Process to date.

On the 1 October 2004 the Commission published CP6/2004 which set out the process that would govern the making of a new determination under the 2001 Act, as amended. CP6 outlined the Commission's decision to publish a separate paper dealing with the legislative changes made to the 2001 Act. It also set out the Commission's intention to engage independent consultants to undertake studies on its behalf regarding the issues of capital expenditure and operational efficiency.

Commission Paper CP7/2004, which was also published on 1 October 2004, discussed the amended statutory objectives and statutory factors in section 33 of the 2001 Act, as substituted by section 22(4) of the 2004 Act. It invited submissions by 1 November 2004 from interested parties as to how the Commission should interpret these amendments. To assist respondents, the Paper summarised the Commission's interpretation of its statutory mandate under the 2001 Act when making the existing Determination. A total of 7 responses were received and published on the Commission's website.

Commission Paper CP9/2004 responded to these submissions and set out the Commission's considered position on how it should implement the revised provisions of section 33 of the 2001 Act and any other provisions in the 2004 Act relevant to the Commission's amended mandate. Most importantly, that Paper represented 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. As stated therein, it is the view of the Commission that the amended statutory objectives permit the continuation by it of the regulation of airport charges imposed at Dublin Airport by DAA with reference to the economic concepts of productive, dynamic and allocative efficiency. By directly stating the Commission's objective as being to facilitate the efficient and economic development and operation of Dublin Airport, the amendment has strengthened the emphasis on economic efficiency as a principle of airport charges regulation. Consequently, this Draft Determination reflects the interpretation as adopted by the Commission on the issues set out in CP9/2004.

As mentioned in CP9/2004, the 2004 Act also amends the 2001 Act by defining a number of terms used therein and how they are to be understood for the purposes of making a determination. The most salient of these are:

"restructuring" has been defined at section 4 of the 2004 Act as meaning -

"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 DAA, Cork Airport Authority and Shannon Airport Authority."

"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."

3.2 Consultants retained by the Commission.

As required by section 33 of the Act, the Commission has considered the operation and development of Dublin Airport from a number of different perspectives. In order to assist it in making its deliberations, several external consultants have been commissioned to provide expert analysis of various parts of the business. This approach echoes the approach used when making the first determination in August 2001. Set out below is a summary of the analytical work undertaken for the Commission by these consultants.

Dublin Airport Traffic Forecasts

Aircraft movement and passenger traffic forecasting is central to the assessment of capital and operational expenditure at the airport. These expenditure figures in turn are used to calculate airport charges. Accordingly, the aircraft movement and passenger traffic forecasts directly influence the setting of airport charges.

Consequently, the Commission has retained consultants, Mott MacDonald to review and evaluate the DAA Passenger traffic and aircraft movement demand forecast and to make an independent assessment of the traffic forecasts at Dublin Airport to assist it in making a determination. Their report is set out at Annex 2.

Capacity Assessment of Dublin Airport

William Hynes & Associates Ltd. (WHA) has been working with the Commission in assessing the capacity of Dublin Airport. DAA and a number of airport users have been engaged in this process. A report on the findings of WHA's preliminary capacity assessment is attached at Annex 3 and is referred to more particularly in Section 8 of this Draft Determination.

Operational Efficiency Assessment of Dublin Airport

Booz Allen Hamilton (BAH) has provided to the Commission a "bottom-up" efficiency assessment of Dublin Airport. DAA and a number of airport users have been consulted in relation to this assessment. BAH's report on its findings which are based on the information that was available at the time of the commencement of the assessment i.e. October 2004, is attached at Annex 4 and is referred to more particularly in Section 5 of this Draft Determination.

Dublin Airport Authority Cost of Capital

Colm Kearney, Professor of International Business at Trinity College Dublin and Elaine Hutson, Lecturer in Finance, University College Dublin were retained by the Commission to provide an estimate of the DAA's weighted average cost of capital (WACC). The WACC is used to determine a reasonable rate of return on investment by the airport company. Their report is attached at Annex 5 and is referred to more particularly at Section 5.

Dublin Airport Authority Commercial Revenue

Alan Stratford & Associates (ASA) were retained by the Commission to undertake an assessment of the DAA's commercial revenue earnings potential at Dublin Airport in the period 2005-14. The total revenue requirement used to calculate the price cap on airport charges is net of commercial revenues in order to apply the single till concept, which the Commission proposes to continue using. The conclusions of ASA's report are attached at Annex 6 and are referred to more particularly in Section 5 of this Draft Determination.

4. DRAFT DETERMINATION

The Commission has sought to illustrate for interested parties, the impact on airport charges of its use of different assumptions in the determination of maximum levels of airport charges for example, concerning Dublin Airport's operating costs or the scale of future investments at Dublin Airport. At the same time, the Commission appreciates that the presentation of too large a number of illustrative scenarios would not be helpful. In this section, indicative levels of maximum airport charges under seven different scenarios are presented:

- Two 'maintenance capital expenditure (capex)' base cases: the Commission's, and the Commission's interpretation of the DAA's business plan;

- The base cases with the DAA's full capital investment plan;

- Three 'improved financial ratios' cases, based on the Commission's base case with full capex.

4.1 Price Base

Calculations in this Paper are expressed in December 2004 prices. Accordingly, the sources of information used - including the financial models of the DAA, and the reports of the consultants - have all been adjusted so that the relevant data is expressed in this price base.

To maintain comparability, the report of the Commission's final determination, which is due no later than 1 October 2005, will also be expressed in December 2004 prices. . Prior to coming into effect in 2006, the levels of maximum airport charges set by the Commission in its determination will be converted by it, as appropriate, to 2006 prices. This will result in an increase of a few percentage points. This increase will correspond with the application of the change in the Consumer Price index as used in the airport regulatory charges formula (CPI-X).

4.2 Indicative Maximum Levels of Airport charges (Price Caps)

The Commission has used the financial model it has developed of the DAA business[3] to compute indicative maximum levels of airport charges (price caps) under the seven scenarios discussed below. The resulting maximum prices, expressed in December 2004 prices, are computed as the annual average over the five years 2006-2010, and are reported in Table 1, along with the present value of the five years of airport charges and, as an indication of financial strength, the FFO:debt[4] ratio. A set of complete 'Yield Tables' for the price caps that show the inputs used in the calculations associated with the various scenarios is contained in Annex 10 of this Paper. The calculation of the price caps, for each of the five years, is explained in more detail in the Explanatory Memorandum (section 5) of this Paper.

Base Case Scenarios (with maintenance capex)

S1: Commission base case: €5.12

This scenario utilises the opening Regulatory Asset Base[5] (RAB) value of Dublin Airport for 2006, and allows a maintenance level[6] of capital expenditure (capex) to roll forward the RAB to 2010. The real pre-tax return is set equal to 7.4%. The operational expenditure (opex) is the Commission's preferred opex baseline, composed of elements of the DAA business plan

[3] IMR Solutions assisted the Commission in constructing this financial model.

[4] The strength of investments as measured by funds from operations (FFO) coverage ratios are important financial indicators.

[5] See the discussion of the Commission's methodology for rolling forward the RAB from the previous determination in section 8.4 of this Paper.

[6] That is, a capex plan which excludes the costs of Pier D, the second terminal and the second runway.

opex together with elements of the Booz Allen Hamilton's (BAH) projected opex. Commercial revenues are as projected by Alan Stratford & Associates (ASA), using the DAA's allocation of EU and non-EU passengers. The resulting revenues are divided by the DAA's centerline passenger traffic forecast.

S2: Commission interpretation of the DAA business plan: €6.11

This scenario utilises the same opening RAB values and maintenance capex as S1. However, the values for opex and commercial revenues are the CAR's understanding of the DAA business plan, and the return is set equal to the DAA cost of capital estimate (8.5%). The resulting revenues are divided by the DAA's centerline passenger traffic forecast.

Base Case Scenarios (with full DAA capex)

S3: Commission base case with capex: €5.94

This scenario employs the same assumptions as S1 but the RAB is rolled forward on the basis of the full capex programme of the DAA in the years 2006 to 2010.

S4: Commission interpretation of the DAA business plan with capex €7.01

This scenario uses the same assumptions as S2 but the RAB is rolled forward on the basis of the full capex programme of the DAA in the years 2006 to 2010.

Base Case (with full capex) and Improved Financial Ratios

S5: Commission base case (with capex) and 18% Funds From Operations (FFO) at the Group level: €6.57

S3's price cap is projected to yield revenues to the company that would give the DAA Group a ratio of Funds From Operations (FFO) to Debt of just under 15%. Scenario 5 uses the same assumptions as Scenario 3, except that the depreciation charge on the RAB is raised sufficiently to give an FFO:debt ratio for the DAA group of 18%.

S6: Commission base case (with capex) and 20% FFO at the Group level: €7.05

This scenario employs the same assumptions as S5 except that the depreciation charge on the RAB is raised sufficiently to give an FFO:debt ratio for the DAA group of 20%.

S7: Commission base case (with capex) and 'stand alone' Dublin Airport FFO ratios: €5.94

Scenario 7 uses the same assumptions as S3, that is, the Commission's base case with the full DAA capex programme for 2006-2010; however, the FFO:debt ratios are re-computed for Dublin Airport on a 'stand alone' basis. This Scenario calculates the impact on the FFO:debt ratio of Dublin Airport after:

- The removal from the DAA's balance sheet of Cork Airport, Shannon Airport, GSH and ARI; and
- The removal from the DAA's future income stream of these entities' Funds From Operations.

(Thus there is no change to the price cap or to the revenues from airport charges; rather, this scenario considers notional DAA balance sheet alternatives.)

Necessarily, both the debt allocations and the FFO projections are subject to considerable uncertainty. The Commission has therefore used different allocations of DAA debt to the other entities' (notional) balance sheets based on (i) Commission estimates of the entities' real net book values (NBV) and (ii) on future earnings shares. Depending on the allocations used, and on other assumptions, the resulting 'stand alone' FFO:debt ratios generally improve to between 18% and 20% from the S3 FFO of 15.4%.

Table 1: Indicative price caps, associated revenues and FFO ratios

	Base Cases		Base with Capex		Base, Capex, Financial Ratios		
Scenario	S1	S2	S3	S4	S5	S6	S7
Price cap	**€5.12**	**€6.11**	**€5.94**	**€7.01**	**€6.57**	**€7.05**	**€5.94**
PV[7] revenues	€467.3m	€543.7m	€541.7m	€623.2m	€599.4m	€643.2m	€541.7m
FFO:debt	18.4%	19.8%	15.4%	16.7%	18.0%	20%	18-20%

These indicative price caps assume a continuation of the present dividend policy of the DAA. The impact of a different dividend policy on the price caps is discussed in section 8 in the context of the DAA's sustainability and financial viability.

The Commission seeks the views of interested parties and the general public on the indicative price caps. The Commission would be grateful if representations could set out cogent arguments and supporting evidence, where possible, in order to assist the Commission to properly consider the views received.

4.3 Sub-Cap on Off Peak Landing and Take-Off Charges

Since its establishment, the Commission has maintained that a cost-reflective airport charging structure and in particular, one that reflected the differing

[7] Present value revenues.

costs of airport use at peak and off peak times, was consistent with its statutory objective of facilitating the development and operation of cost-effective airports.

At the time of making its first Determination, the Commission observed that there were periods in the day when the limitations of existing runway infrastructure were evident, but that existing off-peak traffic (and much of the foreseeable growth in that traffic) could continue to be handled by existing runway infrastructure. Therefore, the Commission decided to place a sub-cap on charges in respect of aircraft movements at off-peak times in order to encourage the introduction of a peak/off peak pricing differential by the airport authority. The Commission's view was that this would contribute to optimal utilisation of existing runway capacity and encourage efficient decision-making in respect of the timing of construction of additional runway capacity, thereby serving its statutory objective.

The methodology underlying the sub-cap itself was based on the principle of cost-reflectiveness such that off-peak landing and take-off charges more accurately reflected the costs of damage to airfield pavements by the movements of different aircraft types (as opposed to the aircraft weight-based system). This was consistent with economic efficiency because the structure of charges reflected the marginal cost associated with an additional movement (landing or take off) of a specific aircraft type. Consequently, this also furthered the Commission's statutory objective.

The Commission also held the view that the efficiency gains from this regulatory intervention would outweigh its cost.

As stated in CP9/2004 and in section 7 of this Paper, the Commission's view is that its amended statutory objectives (pursuant to the 2004 Act) permit the continuation by the Commission of the regulation of airport charges imposed at Dublin Airport by the DAA with reference to the economic concepts of productive, dynamic and allocative efficiency. By directly stating the Commission's objective as being to facilitate the efficient and economic development and operation of Dublin Airport, the amendment has strengthened the emphasis on economic efficiency as a principle of airport charges regulation.

If the circumstances regarding runway utilisation at Dublin Airport have remained unchanged since the making of its first Determination, the Commission would be inclined to maintain the sub-cap on efficiency grounds. If, as is more likely, circumstances have changed, the Commission will review its position in respect of the sub-cap. In particular, it may be the case that there is nothing to be achieved (in terms of efficient runway utilisation) by keeping the sub-cap in place. This would be the case if the airport were now operating at capacity such that there were no periods of under-utilisation that peak/off-peak pricing differentials could encourage airlines to use. In that case, the Commission would be inclined to abandon, at least temporarily, the sub-cap. Alternatively, it may be the case that current circumstances dictate that the off-peak periods, as defined for purposes of application of the sub-cap, are no longer relevant and require revision to reflect these changed circumstances. In that were so, the Commission would be inclined to keep the sub-cap in place but to refine its application to off-peak periods that reflected the current circumstances more closely.

Accordingly, the Commission is undertaking a comprehensive review of 2004 traffic patterns at Dublin Airport to establish whether and how circumstances have changed since making its first Determination. This should reveal:

1. in terms of encouraging efficient utilisation what, if anything, could be achieved by maintaining the sub-cap for the period (or part thereof) of the new Determination and,

2. if the sub-cap were to be maintained, the manner in which the defined off-peak periods, for the purposes of application of the sub-cap, should be amended to take account of current circumstances.

The Commission is also considering its position on the sub-cap in relation to the next tranche of runway capacity becoming operational.

5. EXPLANATORY MEMORANDUM

5.1 Computation of the indicative maximum levels of airport charges (price caps).

The price cap seeks to provide the DAA with a level of revenue that is sufficient to operate and develop airport facilities on an efficient and economic basis in line with the reasonable requirements of current and prospective users.

The estimated revenue requirement is based on the following "building blocks" calculation:

- an allowed return on the RAB; *plus*
- an estimated efficient level of opex; *less*
- an estimated level of commercial revenues (net of cost of goods sold); *plus*
- an allowance for depreciation of the RAB (including depreciation of new investments during the regulatory period).

It also includes an estimate of the Commission's own running costs, in order that the DAA can recoup the sums levied on it by the Commission.

The Commission was required, in its first Determination, to project opex and commercial revenues using a simplistic assumption of a one-to-one linear relationship with passenger traffic. For the purposes of this Draft Determination, these projections have been drawn principally from two independent sources:

- the DAA's own projections; and
- the projections of consultants acting for the Commission.

The corresponding papers of these consultants are published as annexes to this Draft Determination, with certain excisions due to commercial confidentiality.

The main differences in approach (from the first Determination) to calculations underlying the Commission's financial model are:

- all values are in constant prices, expressed in terms of the value of the Consumer Price Index in December 2004;
- the value of the RAB used by the Commission in 2001 has been rolled forward until the end of 2005 by using actual capital expenditure in the intervening years, by eliminating asset disposals and by reinstating the Commission's 2001 asset write-downs for imprudent investments at the end of 2005;[8]
- the RAB includes all Head Office assets and opex includes all Head Office costs, with the impact on charges being given a corresponding offset in the form of an income stream called 'Corporate Recharge', which assumes that these costs are charged to Cork and Shannon airports according to their respective shares of total passenger traffic[9];
- the allowable return is based on an estimate of the DAA's pre-tax Weighted Average Cost of Capital (WACC), i.e., inclusive of the its corporate tax liability, and is applied to a mid-year, i.e., average, RAB value;

The following should also be noted:

- the 1 January 2006 opening RAB includes an estimate of 2005 capex;

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[8] A full description of the Commission's approach to the RAB and the associated calculations are provided in Section 8 of this Paper.

[9] For the first Determination, only the share of Head Office assets attributable to Dublin Airport according to its share of passenger traffic was included in the Dublin Airport RAB.

- the Commission has used, for the purposes of the Draft Determination, the DAA's most recent 'Centreline' passenger traffic forecast (issued March 2005) [10];
- depreciation allowances have, in the case of the opening RAB, been calculated based on depreciation rates in the DAA's Fixed Asset Register applied to indexed historic cost asset values and, in the case of capex, based on rates supplied by DAA in respect of the relevant types of capex project;
- the estimate of DAA's pre-tax WACC is computed as the weighted average of the respective costs of equity and debt finance, with the weights corresponding to the respective shares of equity and debt in DAA's capital structure;
- opex includes both aeronautical and commercial operating costs, taking into account both payroll and non-payroll elements;
- commercial revenues includes revenues other than aeronautical revenues, such as those from retail shops and concessions, catering, car parks, property rents etc.;
- financeability adjustments in the indicative price caps presented in scenarios 5-7 involve changing the time-profile of allowed depreciation, thereby bringing forward revenues to increase FFO coverage;
- the indicative price cap calculations do not take account of under- or over-collection of revenues against the prevailing price cap for 2005.

5.2 Price cap history

By 1 October 2005, at the latest, the Commission must set a new maximum level of airport charges that may be levied by DAA in respect of Dublin Airport. The Commission's intention is that this new price cap will apply from

[10] For purposes of making the final determination, the Commission may consider using a different traffic forecast. In this context, the Commission refers to the Mott MacDonald report at Annex 2.

1 January 2006, thereby bringing to an end the first regulatory period, which will, by then, have run from 24 September 2001 to 31 December 2005. The Dublin Airport price caps that have been in effect for these years are reported in Table 2, in both nominal and constant (December 2004) prices.

Table 2: maximum levels of airport charges for the first regulatory period

Period	Dates		Nominal Price Cap - Dublin	CPI for each period		Price Cap - Dublin in Dec. 2004 Prices
1	09/01 - 09/02	€	5.16	101.53	€	5.58
2	09/02 - 09/03	€	5.10	105.75	€	5.30
3	09/03 - 12/03	€	4.98	106.73	€	5.12
4	01/04 - 12/04	€	5.20	108.64	€	5.26
5	01/05 - 12/05	€	5.15	111.05	€	5.09
Dec. 2004 Prices :			109.80			

In March 2004, as part of the Commission's two-year review of the price caps originally set in 2001 and amended (arising from a referral by the Aviation Appeal Panel) in February 2002, the levels of the price caps in the first two regulatory years were revised to €5.16 (from €5.38) and €5.10 (from €5.32), respectively. The revisions took account of factors such as additional security costs incurred by (the former) Aer Rianta following the events of September 2001, and information that became available to the Commission during the Judicial Review proceedings.[11]

For the third regulatory period, a 99-day transitional period to allow the regulatory and calendar years to be aligned, the price cap at Dublin Airport was €4.98.

The price cap for calendar year 2004 was €5.20.[12] For the calendar year 2005 it was €5.15.[13]

[11] The cap for the second period was €4.95, once account was taken of the CAR budgetary adjustment (the W-term in the regulatory formula) and the adjustment for the over-collection of revenues against the cap (the K-term).

[12] Once account was taken of the cumulative CAR budgetary adjustments (the Ws) and over-collections against the cap during the first two regulatory years (the Ks), the cap for this period was €5.21.

5.3 Indicative Price Cap Computations

This section presents, where necessary, fuller descriptions of the opex and commercial revenue projections and input values used in the various scenarios as well as summarizing the reasons for the differences between those scenarios.

Base Case Scenarios (with maintenance capex)

S1: Commission base case: €5.12

In the Commission's financial model of the DAA's business, opex is broken down into the following 9 categories: (1) security payroll; (2) retail payroll; (3) other airport payroll; (4) other corporate payroll; (5) other retail expenditure; (6) rates; (7) insurance; (8) other airport expenditure; and (9) other corporate expenditure.

The basis for the projections adopted in the Commission's preferred opex baseline for each of these components is outlined as follows. In all cases, the starting point is 2004 expenditure outturns (as supplied to the Commission by the DAA during April 2005[14]) and, except for (5), the most recent DAA budgeted expenditure for 2005.

(1) Security Payroll: projections for 2006-10 use the growth rates implicit in DAA's 2005 projections.

(2) Retail Payroll: projections for 2006-09 use the growth rates implicit in DAA's 2004 projections (as endorsed by BAH), while the 2010 projection uses the growth rate implicit in DAA's 2005 projections.

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[13] €4.90 once account was taken of the W- and K-terms arising from calendar year 2004.

[14] It is necessary to distinguish between DAA's 2005 projections (received by the Commission during April 2005) and DAA's 2004 projections (received by the Commission towards the end of 2004). Only the latter were available when Booz Allen Hamilton commenced its bottom-up efficiency study of Dublin Airport.

(3) Other Airport Payroll: projections for 2006-09 use the growth rates implicit in DAA's 2004 projections (as endorsed by BAH), while the 2010 projection uses the growth rate implicit in DAA's 2005 projections. The projection for 2005-08 includes an incremental efficiency improvement identified by BAH.

(4) Other Corporate Payroll: projections for 2006-09 use the growth rates implicit in the DAA's 2004 projections (as endorsed by BAH), while the 2010 projection is consistent with the DAA's 2005 projections.

(5) Other Retail Expenditure: projections for 2005-09 use the growth rates implicit in the DAA's 2004 projections (as endorsed by BAH), while the 2010 projection uses the growth rate implicit in DAA's 2005 projections. The projection for 2005-09 includes an incremental efficiency improvement identified by BAH.

(6) Rates: projections for 2006-10 use the growth rates implicit in DAA's 2005 projections.

(7) Insurance: projections for 2006-10 use the growth rates implicit in DAA's 2005 projections.

(8) Other Airport Expenditure: projections for 2006-10 use the growth rates implicit in DAA's 2005 projections. The projection for 2005-09 includes an incremental efficiency improvement identified by BAH.

(9) Other Corporate Expenditure: projections for 2006-10 use the growth rates implicit in DAA's 2005 projections. The projection for 2005-09 includes an incremental efficiency improvement identified by BAH.

Commercial revenues are broken down into the following 7 categories: (1) retail sales non-EU; (2) retail sales EU; (3) other retail income; (4) car park revenue; (5) property revenue; (6) other airport revenue; and (7) corporate revenue. The projections are based on the conclusions of the ASA report on the DAA's commercial revenue earnings potential at Dublin Airport, with one adjustment by the Commission; that of using the DAA's separate EU and non-EU passenger traffic forecasts to project revenues from DAA's retail sales.

The indicative price cap of €7.01 presented in Scenario 4 (S4) is the result of the Commission's extrapolation, using its own financial model, of the DAA's most recent financial projections. The differences between the DAA's base case (the S4 cap) and the Commission's base case (the S1 cap of €5.12) are set out in Table 3 below.

Table 3: differences between S4 and S1

CAR adjustments	2006-10 Ave. €/pax
Required price for DAA projections	€7.01
Effect of CAR cost of capital	-€0.39
Effect of CAR opex adjustments	-€0.25
Effect of CAR commercial revenue adjustments	-€0.43
CAR base case scenario	€5.94
Assuming base capex only (excluding major projects)	-€0.82
Base case starting point	€5.12

Starting from €7.01, the effect of applying a 7.4% cost of capital (as estimated by Kearney and Hutson) as opposed to the DAA's figure of 8.5% (as estimated by NERA[15]) is a €0.39 per passenger reduction of the DAA's base case. The Commission's opex adjustments result in a €0.25 per passenger reduction and using the Commission's adjusted (see above) ASA estimates of DAA's commercial revenue earnings potential reduces the DAA's base case by a further €0.43 per passenger. Removing the costs of capacity-driven capex projects (Pier D, the second terminal and the second runway) from the resulting €5.94 (a per passenger reduction of €0.82) reconciles the DAA base case with the Commission's base case of €5.12.

Table 4[16] provides a breakdown of the per passenger opex adjustment of €0.25. The column labelled "2004 Projections" are the per passenger reductions arising from the application of the growth rates implicit in the

[15] NERA Economic Consultants' report on the cost of capital for the DAA is set out at Annex 8.

[16] Due to the effects of rounding to an additional decimal place, the totals in tables 4 and 5 do not exactly match the individual adjustments.

DAA's 2004 projections (see details above). The column labelled "BAH/CAR" are the further per-passenger reductions arising from the incremental efficiency improvements identified by BAH.

Table 4: underlying opex adjustments

Opex adjustments	2004 Projections	BAH/CAR	Total
Retail payroll	€0.03	€0.00	€0.03
Other airport payroll	€0.02	€0.07	€0.08
Corporate payroll	€0.11	€0.00	€0.10
Other retail expenditure	€0.00	€0.00	€0.00
Other airport expenditure	€0.00	€0.02	€0.02
Other corporate expenditure	€0.00	€0.01	€0.01
Total effect of opex adjustments	€0.15	€0.10	€0.25

Table 5 provides a breakdown of the per passenger commercial revenue adjustment of €0.43.

Table 5: underlying commercial revenue adjustments

Commercial revenue adjustments	2006-10 Ave. €/pax
ASA retail adjustments, as amended by CAR	€0.09
ASA car park revenue adjustments	€0.12
ASA property revenue adjustments	€0.21
ASA other adjustments	€0.02
Commercial revenue adjustments from ASA analysis	€0.43

S2: Commission interpretation of the DAA business plan: €6.11

As outlined in Section 4, scenario S2 uses the DAA's 2005 projections of opex and commercial revenues. This, combined with the application of NERA's 8.5% estimate of the DAA's cost of capital, results in a €0.99 per passenger differential between the DAA's base case (excluding the costs of capacity-driven capex projects) and the Commission's base case of €5.12 (S1).

Base Case Scenarios (with full DAA capex)

S3: Commission 'base case' with capex: €5.94

As outlined in Section 4, scenario S3 employs the projections and assumptions of S1 (see detail above) in respect of opex and commercial revenues. The €0.82 per passenger difference between the S3 and S1 indicative price caps arises from the fact that the allowed return (equal to the 7.4% cost of capital as estimated by Kearney and Hutson for the Commission) and depreciation are calculated on the basis of a RAB that is being rolled forward on the basis of the DAA's full envisaged capex programme during the period 2006-10.

> **S4**: Commission interpretation of DAA business plan with capex: €7.01

As outlined in Section 4, scenario S4 (like S2) employs the DAA's projections of opex and commercial revenues. The €0.90 per passenger difference between the S4 and S2 indicative price caps arises from the fact that the allowed return (equal to the NERA's 8.5% estimate of the DAA's cost of capital) and depreciation are calculated on the basis of a RAB that is being rolled forward on the basis of the DAA's full envisaged capex programme during the period 2006-10.

Note that the per-passenger difference between scenarios S4 and S2 (€0.90) is greater than the per-passenger difference between S3 and S1 (€0.82). This is because, although the RAB is growing in magnitude at the same rate in S4 and S3 (as well as in S2 and S1), the greater allowed return in S4 results in greater differences (relative to S2) than in S3 (relative to S1).

As noted in Section 5.2 (footnote 10), the prevailing price cap for calendar year 2005 (having taken account of the W- and K-terms) is €4.90. The differences between this cap and the indicative S4 price cap of €7.01 are illustrated in Table 6.

Table 6: differences between S4 indicative cap and prevailing 2005 price cap

	CPI Dec 2005	CPI Dec 2004	2006-10 Ave. €/pax
DAA business plan[17]	111.1	109.8	
2005 revenue/pax per DAA forecast			€4.82
Adj. to 2004 Compliance Report	€5.15	€5.09	€0.27
Price increase required for steady state business			€1.71
Steady state business			€6.81
Additional pensions costs and pay inflation			€0.42
Commercial revenue improvement in 2005			-€0.05
DAA projected deterioration in commercial revenues thereafter			€0.36
Effect of growth on operations (opex 0.56 times pax growth)			-€1.73
Growth-related capex			€0.82
Cost of capital assessed by DAA			€0.39
Price required for DAA business plan			€7.01

Starting with the current cap (and re-basing to December 2004 prices), Table 6 shows that some €0.27 of the difference is due to the W- and K-term corrections for revenues collected against the price cap during 2004.

A further €1.71 was calculated as being required for a 'steady-state' price cap, defined as one sufficient to cover costs in the event of zero passenger growth, constant (2005) levels of opex and commercial revenues, and maintenance capex (excluding capacity-driven projects).

Re-introducing the non-growth related opex increases implicit in the DAA's 2005 projections (which includes higher employer pension costs and wage inflation) adds €0.42 to the cap. The 2005 per passenger improvement and 2006-10 deterioration in commercial revenues implicit in the DAA's 2005 projections results in a net addition of €0.31 to the cap.

The deduction of €1.73 takes account of the per passenger reduction in the steady-state levels of both operating and capital costs arising from the DAA's forecasted passenger growth as well as the less rapid growth-related

[17] This table represents the Commission's interpretation of the DAA business plan.

increases in operating costs (0.56 times passenger growth). The overall effect is, therefore, one of scale economies.

The two remaining increases are the per-passenger effects of the DAA's capacity-driven capex (€0.82) and the use of NERA's 8.5% estimate of DAA's cost of capital (rather than the Kearney-Hutson estimate of 7.4%) as the basis for an allowed rate of return.

Therefore, the indicative price cap of €7.01 based on the Commission's interpretation of the DAA business plan requires an uplift of €2.19 on the prevailing adjusted (for the 2004 W- and K-terms) 2005 price cap and an uplift of €1.92 on the unadjusted 2005 price cap.

Base Case Scenarios (with full capex) and Improved Financial Ratios

> **S5**: Commission base case (with capex) and 18% Group FFO;- €6.57.

Scenario S5 replicates S3, but alters the time-profile of allowed depreciation on the RAB, thereby bringing forward revenues to increase FFO coverage from 15.4% to 18%.

> **S6**: Commission base case (with capex) and 20% Group FFO:- €7.05.

Scenario S6 replicates S3, but alters the time-profile of depreciation on the RAB, thereby bringing forward revenues to increase FFO coverage from 15.4% to 20%.

> **S7**: Commission base case (with capex) and 'stand alone' Dublin Airport FFO ratios: €5.94

Further detail is provided in Section 4.

5.4 Sustainability and Financial Viability

The Commission, in order to meet the statutory objective of enabling DAA to operate and develop Dublin Airport in a sustainable and financially viable manner, must reach decisions on the following significant financial issues:

- the DAA's cost of capital;
- the sustainability and financial viability of DAA's activities; and
- the estimated deficit in DAA's pension scheme.

The Commission will not reach decisions on these matters until any and all views of interested parties have been considered. However, the Commission has sought to present a range of options for the purposes of consultation and would encourage the receipt of representations setting out cogent arguments and, where possible, supporting evidence in order to assist the Commission in properly considering those views.

Cost of Capital

On the cost of capital, the DAA engaged NERA Economic Consultants, who estimated the company's WACC on a real pre-tax basis at 8.5%. NERA's report is attached at Annex 8. The Commission retained Colm Kearney, Professor of International Business, Trinity College and Dr Elaine Hutson of the Smurfit Business School, Dublin, to estimate the company's WACC. They estimated the WACC on a real pre-tax basis at 7.4%. Their report is attached at Annex 5.

The Commission has made no decision on the value of the cost of capital on which to base the allowable rate of return that will be used to calculate the price cap on Dublin Airport. However, in the indicative scenarios above, it has presented the per passenger effect of using the two values that were available to it. The Commission seeks the views of interested parties on the appropriate cost of capital and, once again, would like to emphasise its wish to receive representations setting out cogent arguments and, where possible, supporting evidence in order to assist it in properly considering those views.

Pension Deficit

The indicative price caps set out above include (in the opex projections) the higher pension contributions foreseen by the DAA. However, this treatment of the pension deficit is made entirely without prejudice to the Commission's eventual approach on this matter and is, in particular, still considering the following aspects of the issue:

- the magnitude of the deficit using different measures;
- the proportion that it is appropriate to fund through airport charges levied at Dublin Airport;
- the regulatory treatment of any deficit might be included for the purposes of calculating the price cap, for instance, whether through an allowance through forecasted payroll or through capitalization in the RAB.

The Commission seeks the views of interested parties on the appropriate treatment of the DAA's pension deficit and, once again, would like to emphasise its wish to receive representations setting out cogent arguments and, where possible, supporting evidence in order to assist it in properly considering those views.

6. PERIOD OF THE DETERMINATION

Section 32(5)(a) of the 2001 Act provides that the Determination shall be in force for a period of “not less that 4 years.” The Commission sees merit in having a Determination in excess of the statutory minimum in order to provide the airport authority and its users (as defined in the Act) with the stability necessary to facilitate long term planning in relation to the development, operation and the use of the airport. It is of course, the case that the length of a Determination is to a certain degree, constrained by the information available at the time of its making. The Commission is proposing a term of 5 years in the Draft Determination and may consider a different term for the final Determination[18].

Furthermore, Section 32(5)(b) provides that the Determination shall come into force on such day as the Commission specifies. The Commission therefore has decided to designate 1 January 2006 as the date that the determination shall come into operation in order that it continues to operate on a calendar year basis.

[18] Section 35(3) of the 2001 Act, as substituted, states that a determination shall be in force for a period of not less than 4 years and shall come into operation on such day as the Commission specifies.

7. STATUTORY OBJECTIVES

Section 33(1) of the 2001 Act, as substituted by section 22(4) of the 2004 Act, states that:

"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;

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

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

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 require it to continue to regulate airport charges with reference to the economic concepts of productive, dynamic and allocative efficiency. 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 development and operation of Dublin Airport, the amendment has in the Commission's view, strengthened the emphasis on economic efficiency as a principle of airport charges regulation. In addition to the statutory objective, the Commission is required to have due regard to a number of factors, which have also been amended by the 2004 Act.

In interpreting the new objectives, the Commission has equated:

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.

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 is also of the view that providing for the regulated firm to earn a reasonable rate of return on capital employed in the business, thereby allowing its sustainable and financially viable operation, is in the interest of users and, as outlined in the previous paragraph, facilitates dynamic efficiency. In this regard statutory objectives (a) and (b) are closely linked.

The Commission has noted that “users” is now defined under the Act and explicitly applied to a broad group of persons that have a nexus to the airport.

The statutory objective of financial sustainability and viability

One of the Commission's objectives in making a determination, under Section 22 of the 2004 Act is to enable DAA to operate and develop Dublin Airport in a sustainable and financially viable manner. The Commission must balance this objective with its other objectives that require it to protect the reasonable interests of current and prospective users of the airport and to facilitate its efficient end economic development and operation. In some respects, these three objectives reinforce each other – for example, financial viability is a necessary condition for the airport's efficient and economic development and for customer charges to reflect an efficient cost of financing those developments.

In evaluating what an appropriate financial foundation might look like, the Commission is guided by its analysis of DAA's financial position and the uncertainties involved. The Commission has assessed these matters by calculating a range of financial ratios used by the credit rating agencies and the financial community[19]. These are:

- FFO[20]: debt ratio, for which a threshold value of 20% has been used for the draft determination;
- FFO cover, for which a threshold value of 2.5 has been used;
- EBITDA[21] cover, for which a threshold value of 2 has been used;
- EBIT[22] cover, for which a threshold value of 1.5 has been used; and
- AICR[23] cover, for which a threshold value of 1.5 has been used for the draft determination.

The Commission has considered the perspectives of the agency that provides a credit rating for DAA's Eurobond, Standard & Poor's (S&P)[24].

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[19] See scenarios 5 – 7 at sections 4.2 and 5.3.

[20] Funds from operations.

[21] Earnings Before Interest Tax Depreciation and Amortisation.

[22] Earning Before Interest and Tax.

[23] Adjusted Interest Cover Ratio.

At present, DAA's credit rating is classed as single A, with a negative credit watch / A-1. S&P has explained to the Commission how it rates an airport company such as DAA and emphasised that it considers the underlying risks in the economic and political environment, not just financial metrics. The underlying economics of Dublin airport are strong – it is an essential facility for a major population centre in a strong economy with a government as the shareholder.

S&P identified the two main types of measure that it watches particularly closely. The first is interest cover, primarily the FFO interest cover ratio, which relates the cash flows from the company's operations to the level of interest payments that the company has to make. The agency is looking to see that the company has sufficient cash resources to fund interest and withstand reasonable cost or revenue shocks. The second relates those same cash flows to the level of outstanding debt (the FFO to debt ratio).

For DAA, projected interest cover ratios do not look weak, even during the period of highest investment activity. In part, this appears to reflect the relatively low real interest rates that have prevailed and continue to prevail in the euro zone. The FFO to debt ratio is more problematic. This ratio reflects the underlying financial position of the company in a way that is not affected by current rates of interest that may vary in the future. S&P would be looking for evidence that the company should be able to sustain a ratio in excess of 20%. In the DAA's last accounts, the ratio was little over 15%, and the 2003 accounts showed an even lower ratio, but S&P indicates that a more sustained pattern at these levels could threaten the company's current rating. A deterioration in its rating would be expected to have an adverse impact on its cost of borrowing, ultimately to the detriment of airport charges that must support this cost.

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[24] Prior to making its Determination, the Commission will consider whether the S&P perspective is sufficiently representative of the financial community as a whole, and whether it may be necessary to illicit other perspectives.

The Commission's calculations suggest that, in most circumstances, DAA's FFO to debt ratio should rise to levels well in excess of 20% in the long run, but the position in the period 2006 to 2010 is very much affected by the level of capital expenditure. Even with full provision in airport charges for the additional depreciation associated with the company's full capex programme ,the cost of financing a major investment programme and without taking any account of the uncertainties involved, the Commission's calculations suggest that the FFO to debt ratio would stay at about its current low level for at least the next five years. Without the major projects, the ratio would be on a sound upward trend.

The key question

A key question, and perhaps the defining question for this consultation, is whether the new statutory objective of financial viability objective in Section 22 of the 2004 Act requires an upward adjustment in the Commission's calculation of the airport charges cap in order to enable Dublin Airport's sustainability and financeability?

Precedents and mechanisms

There are some regulatory precedents for making this kind of adjustment. Similar adjustments have recently been made by UK regulators in the 2004 reviews for the water and electricity sectors, in the case of water representing about 1% of the price cap. An aviation sector precedent was set by the UK's CAA in its August 2000 report on the charge control for NATS's UK En Route business in which it included depreciation adjustments "tempering the potential problems with financing NATS's business"[25]. The 2004 regulatory accounts for NATS shows this was £19.7 million, some 4% of total external revenue.

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[25]National Air Traffic Services (NATS) provides air traffic control services to aircraft flying in UK airspace and over the eastern part of the North Atlantic.

The Commission would only propose making any adjustment on the basis that it reflects an acceleration of depreciation on the RAB, so that any additional revenues from users are reflected in a lower asset base for the company in later years. In this way, any adjustment in the price cap would not result in a longer-run gain in the present value of revenues to the company but it would mean users paying a larger proportion of those revenues in the next control period.[26]

Scale of potential adjustment

Section 4 describes key financial modelling scenarios that have informed the Commission's analysis. It shows that the average airport charges per passenger over the period 2006 to 2010 would have to be adjusted by close to €0.50 (an average of €6.57 in scenario 5 versus €5.94 in scenario 3) to give an average FFO to debt ratio of 18% over the period and an increase of a further €0.50 (to €7.05 in Scenario 6) to bring the projected ratio up to 20%. These average charges could be €0.30 to €0.40 lower if the company were to declare no dividends to its shareholder over the period. The figure of €0.50 represents about 10% of the current per passenger charges, suggesting a rather larger financeability adjustment than the regulatory precedents referred to above.

Possible mitigating factors

Firstly, although the Commission's analysis of risk factors will not be complete until later in this consultation process, its financial modelling so far does not indicate that the potential scale of investment is so great that the underlying longer-term cash flows could not support it being funded through

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[26] The Commission notes the balance it must strike in making such an adjustment between serving the interests of current and prospective users or, in economic terms, between the objectives of allocative and dynamic efficiency. This will be assessed further prior to the making of the Determination.

borrowing. The issue is whether the shorter-term cash flow implications will either be so severe that lenders will not be willing to provide new facilities or that they will only be willing to do so on more expensive terms that will unduly increase the financing costs to the detriment of users. The Commission's discussions with S&P suggests that ratings will give due weight to the underlying risk issues rather than focus unduly on individual financial measures in isolation.

Secondly, in many normal commercial circumstances, an investment programme of this scale might be funded in part through equity rather than debt, either by shareholders providing new equity capital or accepting a period of low or zero dividends.

Thirdly, the financial indicators relevant to a credit rating are currently the indicators for the DAA group as a whole, using financial information in the consolidated group accounts. A divestment of some of the group's businesses is anticipated in the 2004 Act, although the terms for those divestments have not yet been decided by the Government. As described in Section 4.2, the Commission has carried out analysis to calculate what the projected financial indicators might be for Dublin Airport on a stand-alone basis. The calculation depends critically on assumptions about the allocation of debt between the group's various businesses, but an allocation according to historical levels of investment, i.e. equating debt to investment, would improve the FFO to debt ratio for the stand-alone airport substantially towards 20%. Depending on the terms, divestments or any other restructuring of the group may have a significant effect on DAA's financial indicators that may require corresponding adjustments to the price cap[27].

Finally, there may be alternative regulatory and mechanisms modifying the allocation of risk between users and investors thus improving financial

[27] Note the indicative price cap scenarios set out at section 4.2 further explained at section 5.3.

sustainability from the investor's perspective[28]. This may also help reduce the cost of capital. The Commission is also aware that establishing a clear regulatory framework for the airport to provide greater certainty for managers and investors about future regulatory decisions would also help underpin positive ratings for the company's debt.

[28] Without prejudice to the Commission's future decisions, regulatory mechanisms of this kind might include (without being limited to) a rolling treatment of opex efficiencies, and traffic reviews, as well as financial mechanisms relating to stand-by credit, and the precise terms of financial covenants.

8. STATUTORY FACTORS

Section 33(2) of the, 2001 Act as substituted by section 22(4) of the 2004 Act sets out nine factors to which the Commission must have due regard when making a determination on airport charges. Consideration of each is set out below.

1. *"the restructuring including the modified functions of Dublin Airport Authority."*

The 2001 Act, as amended, states that the Commission must make a new determination by the 1 October 2005. It goes on to state at section 33(2)(a), that restructuring within the meaning of the 2004 Act does not have to be taken into account unless Cork and Shannon Airport Authorities are vested with the ownership and management of their respective airports within that time.

2. *"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".*

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.

Accordingly, the Commission seeks submissions from all users on the DAA Capex Programme as set out in Annex 7. Interested parties should also bear in mind the Dublin Airport Passenger Survey set out at Annex 10.The Commission will seek to match capacity-driven capex with its conclusions on capacity deficits at the airport. Such an analysis will be informed by WHA's capacity assessment (Annex 3) as well as capacity assessments undertaken by or on behalf of DAA or other interested parties. Interested parties are requested to comment on the WHA capacity assessment, particularly as to how accurately it reflects existing capacity constraints at the airport.

3. *"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."*

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

Furthermore, it is of the view that its general 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.

The Commission has included commercial revenue in the regulatory till. Commercial revenue at Dublin Airport comprises retail income from its own DAA shops and other retail concessionaires, property income, car parking revenue and income from operating concessionaire and rentals. Set out at Annex 6 are the main conclusions of Alan Stratford and Associates Limited report undertaken on behalf of the Commission that provides an assessment of commercial revenue earnings potential at Dublin Airport over the period 2005-2014.

4. "*Costs or liabilities for which Dublin Airport Authority is responsible*."

The Commission notes that when making a determination on airport charges at Dublin Airport it must have regard to the costs or liabilities for which DAA is responsible. If costs incurred by the airport authority other than at the airport were 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 of CP9/2004, i.e., marked down to zero in its determination of airport charges.

In such a scenario, the effect of a transfer of debt of ART (Aer Rianta Teoranta) to the DAA would be to change the capital structure of the company, reducing the share of equity and raising that of debt. Consequently, the implied level of equity would be the residual of the RAB 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 RAB but accepts that it may have an impact on the assessment of the reasonable rate of return.

DAA Pension Scheme

The company's pension scheme - the Irish Airlines Superannuation Scheme (IAS) - is a multi-employer scheme and DAA is a minority employer in this scheme. Consequently DAA's level of control and involvement reflects this situation as opposed to a conventional pension scheme.

The Commission understands that the Appointed Actuary to the IAS scheme has advised that increases in contributions to the scheme will be required in order to maintain current benefit levels being paid by the scheme.

As stated in the company's 2004 Annual Report, the view of the DAA Board is that, subject to Ministerial approval, the DAA intends to establish a new pension scheme. This position is supported by the company’s professional advisers.

Accordingly, the DAA has advised the Commission that its pension costs are expected to rise significantly into the future if the current level of benefits is to continue.

For the purpose of the Draft Determination and without prejudice to the Commission's future policy decisions, the indicative price caps set out in section 4 of this paper are based on levels of operating expenditure that include higher future levels of employer pension contributions."

Regulatory Asset Base (RAB)

In line with regulatory practice, the Commission intends to roll forward the value the RAB.

The RAB is a regulatory valuation of the regulated business, on an enterprise value basis, i.e. debt plus equity. It is the asset base for the purpose of calculating an appropriate level of return for investors, the parties who have an interest in the debt and equity of the business. The Commission can then determine maximum levels of airport charges that would provide investors, with a return equal to the weighted average of the cost of debt and cost of equity (WACC). The Commission also assesses the WACC.

In its first Determination (CP8/2001), the Commission established an initial valuation of Dublin Airport's RAB, which it based on a valuation of the Indexed Historical Cost of the Net Fixed Assets as at 31 December 2000 prepared by Aer Rianta, adjusted for both the investment at Pier C considered to have been imprudently incurred, certain 2001 capex and stands that were considered to be surplus to the current capacity requirements. The RAB also includes an allocation of a similar valuation of assets used by Aer Rianta's Head Office to provide shared services to all three of its airports. The initial valuation formed the basis for an annual forecast of the RAB value, by adding expected capital expenditure and deducting depreciation in each year.

In the Revised Determination (CP2/2004), a further adjustment was made to the projections of the RAB to take into account 75% of the capital expenditure connected with security requirements On this basis, the value of the RAB for Dublin Airport, used by the Commission for its calculations in CP8/2001,was identified as €614,129,457 at 1 January 2004.

For the purpose of this Draft Determination it is necessary to roll forward the initial valuation of the RAB to identify an appropriate forecast of its value as at 1 January 2006 and for each subsequent year of the next control period. These RAB values are used to calculate the appropriate level of return for each year of that period.

The Commission has considered carefully the regulatory principles relevant to this calculation. It recognises that, although its initial value was established as the aggregate valuation of the indexed fixed asset register, the RAB is not a fixed asset account but an enterprise valuation rolled forward for a well defined economic purpose – specifying maximum levels of airport charges having regard to the Commission’s statutory objectives. The two most relevant of these relate to economic incentives and financial viability. These objectives are not fundamentally unique to airport regulation in Ireland and so the Commission’s consideration has been informed by regulatory practice in other sectors, notably the airports sector in the UK.

In rolling forward the initial valuation of the RAB, the Commission considers it appropriate to increase the RAB to reflect in a fair manner the value of net investment (expenditure on assets less the value of asset disposals) appropriately made by the company in enhancing and maintaining airport assets for the purpose of delivering airport services. The Commission also considers that it is appropriate to reduce the RAB to reflect the contribution made by users towards those assets in the depreciation allowance calculated at each price review. Other adjustments may also be appropriate to maintain appropriate incentives for efficient performance by the company, for example:

The Commission is considering the following specific questions:

- whether adjustments made in the initial valuation of the RAB for imprudently investment should be reversed or fixed as a permanent adjustment to the RAB;

- whether adjustments should be made for savings in capital expenditure that were not a result of efficiency but instead a result of change in the scope or output of the capital programme.

When valuing the RAB, the prudence with which capital expenditure has occurred is taken into consideration. In common with other regulators, the Commission considers that it would be appropriate for the company to retain the financial benefit of efficiency savings in capital expenditure at least for the duration of the price control period, i.e. a maximum of five years. Some regulators extend this approach and adopt a rolling incentive mechanism that secures a full five years of benefit for the company, even for savings made towards the end of a control period. Users would benefit, in due course, from the fact that the RAB will be lower than it would if those savings had not been made. The company is thus incentivised to make efficiencies that benefit users in due course.

The Commission considers that the integrity of incentives depends on this principle being symmetrical – if the company only has a few years' worth of reward for efficiency, it should also only have a few years' worth of penalty for inefficiency. The Commission considers that an asymmetrical incentive could encourage an unduly risk-averse approach in the company's management of its capital programme, which would tend to be to the disadvantage of users in the longer term. The returns allowed within the existing price control have not included a return on the expenditure considered to be imprudently incurred so that, by 31 December 2005, the company will have suffered a penalty for a full four years. The Commission considers that it would be consistent with its general approach to incentives (which does not yet include a rolling incentive mechanism) to reverse those adjustments in its calculation of the RAB at 1 January 2006.

The Commission is conscious that capital expenditure incentives will be especially important over the next control period, when the company faces a sizeable investment programme. The effective design and implementation of that programme would benefit users for many years to come and the adverse impact on users of poor management of this programme could be considerable. The Commission plans to develop its approach to capital programme incentives in advance of its final determination in the autumn, but seeks to adopt a consistent approach, where appropriate, in its calculation of the rolled forward RAB.

The Commission recognises the important distinction between the effects of efficiency and the effects of a change in scope. It would be appropriate for a company to retain some reward for making efficiencies that benefit users in due course. It could be considered perverse, to permit a company to retain similar rewards for savings made by not building the assets that users reasonably required and have been asked to contribute towards. The Commission is therefore considering whether it should reduce the RAB to reflect the value of income calculated in earlier determinations that users have paid but that can be attributed to Pier D investment that has not taken place.

Accordingly, for its Draft Determination, the Commission has rolled forward the initial valuation of Dublin Airport's RAB, which was based on a valuation of the Indexed Historical Cost of the Net Fixed Assets as at 31 December 2000 prepared by Aer Rianta. It has reversed the adjustments made in earlier determinations in respect of imprudent expenditure on the basis that the appropriate incentive period for the company to be penalised for that additional expenditure is shortly to expire. It has added to that initial valuation the actual expenditure less the value of disposals, disclosed in audited regulatory accounts, on Dublin Airport (and the company's Head Office in respect of services shared between its three airports) for the years to 31 December 2004 and the current forecast for 2005. It has also deducted the aggregate depreciation allowances that were included in the price cap calculations in previous reviews for the period up to 31 December 2005.

Subject to consultation, the Commission has not made further adjustments in respect of income that can be attributed to Pier D investment that has not taken place.

The resulting calculation of the rolled forward RAB coincides very closely with a valuation of Indexed Historical Cost fixed assets at 31 December 2004 provided to the Commission by DAA, after rolling forward for transactions and depreciation in 2005. The closeness of these results has led the Commission to conclude that it can safely adopt the more recent detailed fixed asset analysis prepared by DAA as the basis for the revised RAB value.

Cost of Capital

In relation to the assessment of the rate of return allowable to DAA report the Commission has sought and obtained expert advice. Set out at Annex 5 is a paper prepared by Colm Kearney, Professor of International Business at Trinity College Dublin and Elaine Hutson, Lecturer in Finance, University College University[29], on DAA's cost of capital. The Commission has used their finding of a reasonable rate of return (on a pre-tax basis) for the period of the determination of 7.4% in certain indicative price cap scenarios in this Draft Determination For comparative purposes, set out at Annex 8 is the executive summary of the report commissioned by DAA on its cost of capital prepared by NERA Economic Consultants. Their findings have similarly been used in certain of the above-mentioned scenarios.

5. *"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."*

In the Determination, the Commission will attempt to define levels of service quality to be achieved during the regulatory period. To the extent that service quality is measured by physical capacity, the recoverable capex allowed by the Commission will be of sufficient size to allow the airport authority to add the required physical capacity.

To the extent that service quality is measured by operational performance, the Commission will seek to set the appropriate indices and monitor performance against them.

[29] Annex 5.

Accordingly, the Commission seeks submissions on the appropriate indices of operational performance. Such submissions should take into account the broad scope of users as set out in the Act which include airlines, passengers, cargo operators, concessionaires, ground handlers, suppliers and other users of airport services. Without seeking to limit the scope of the discussion, the Commission sets out the following indices for consideration:

- availability of contact stands
- availability of trolleys
- cleanliness of terminal, washrooms, gate areas
- availability of way-finding and flight information
- time passengers spend in security queues
- availability of equipment (air bridges, outgoing baggage systems, incoming baggage systems, escalators, ground power, lifts and travelators)
- providing for the needs of passengers with reduced mobility

6. *"Policy statements, published by or on behalf of the Government or Minister of the Government and notified to the Commission by the Minister, in relation to the economic and social development of the State."*

The Commission wishes to confirm that to date, no such notifications have been received. Consequently there are no matters to be taken into account in the Draft Determination in respect of this factor.

7. *"the cost competitiveness of airport services at Dublin Airport."*

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).

In considering how to take due regard of this factor when setting its indicative maximum levels of airport charges, the Commission has relied upon the bottom up efficiency study of Dublin Airport prepared by Booz Allen Hamilton, which is set out at Annex 4.

In order to widen the debate and give interested parties food for thought during this consultation process on airport charges the Commission also engaged Air Transport Research Society (ATRS) to prepare a report applying ATRS Global Airport Benchmarking Study methods to Dublin Airport in order to assess Dublin Airport's performance in comparison with the major European airports included in the ATRS Benchmarking report.

Similarly, the Commission engaged Transport Research Laboratory (TRL) to prepare a report producing a set of benchmarking results for Dublin Airport alongside the analysis of other airports in their publication "Airport Performance Indicators".

The findings of the comparative reports of the TRL and the ATRS on the performance of Dublin Airport are set in the paper at Annex 11.

8. *"imposing minimum restrictions on Dublin Airport Authority consistent with the functions of the Commission."*

The Commission has stated previously that it was of the view that no change in policy was needed regarding this factor. By proposing an overall price cap on airport charges, the Commission will be affording a large measure of discretion to DAA.

However, as stated in section 32(6) of the 2001 Act, the determination may "operate to restrict increases in any such charges, or to require reductions in them, whether by reference to a formula or otherwise." Accordingly, the Commission will consider the continued application of the sub-cap on off-peak landing and take off charges.

Other than this restriction, DAA will be free to adopt its own charging structure. In this manner, the Commission has sought to minimise restrictions on DAA consistent with its own statutory functions and those of DAA.

9. *"such national and international obligations as are relevant to the functions of the Commission and Dublin Airport Authority."*

The Commission stated in CP9/2004 that it considered that this provision is self-explanatory and proposed no change in policy from its approach in the previous determinations. Although the wording of the provision has now been expanded to make it clear that it is obligations on both the regulator and the regulated firm that must be considered, the Commission had in practice approached its role in that manner from the outset.

9. ANNEXES

9.1 Annex 1 - Deadline and Process for Receipt of Representations

In paragraph 5.3.2 of Commission Paper CP6/2004, the Commission set out the meaning of deadlines imposed by the Commission in the context of its process leading to a determination on airport charges. That paragraph states that where a date is expressly or impliedly stipulated as a deadline, the closing time for receipt of submissions is 5:00pm on the date in question. In order to ensure that the Commission acts at all times in a fair, transparent and non-discriminatory manner, the Commission is concerned to ensure that all parties making representations in respect of the proposed determination are clear about the meaning of the deadline set for receipt of such representations and the consequences of failing to meet the deadline. The deadline for receipt of representations with respect to the proposed determination on the maximum level of airport charges is 5:00pm on the 1 July 2005 (the "deadline").

Representations should be addressed to:

Mr. Cathal Guiomard,
Head of Economic Affairs,
Commission for Aviation Regulation,
3rd Floor,
Alexandra House,
Earlsfort Terrace,
Dublin 2.

Any party intending to make representations to the Commission on the proposed Determination should note the following conditions, which the Commission will apply with respect to the receipt of representations and the meeting of the deadline.

1. Subject, where applicable, to the specific rules set out in subsection 6 below, the time of receipt of representations by the Commission, whether in electronic form or otherwise, shall be the time when the representations are actually received at, or in, the offices of the Commission whether sent by post, courier, hand delivery, fax, e-mail or otherwise and all references to "received by the Commission" shall be construed accordingly.

2. The onus will be on the party making representations to the Commission to ensure that the representations are received by the Commission on or before the deadline.

3. The Commission accepts no responsibility and will make no allowances for delays or technical faults, which arise otherwise than as a direct result of an act or omission of the Commission, howsoever caused, and which result in representations being received by the Commission after the deadline or which result in part only of the representations being received by the Commission on or before the deadline.

4. Representations, which are received by the Commission after the deadline, will be deemed not to have been received by the Commission and the Commission will not take them into account. If a portion of representations are received by the Commission on or before the deadline and the remaining portion received after the deadline, then only that part received by the Commission on or before the deadline will be taken into account by the Commission. The remaining part will be deemed not to have been received by the Commission.

5. In determining the time at which representations are actually received by the Commission, in accordance with the rules set out in this Annex, the Commission shall use the clock settings, time and date stamps in use in the offices of the Commission for Aviation Regulation, on its fax machine and on its information systems, as appropriate.

6. The Commission envisages that it may correspond with interested parties who have made submissions for clarification or explanation of their submission. Such correspondence is not an invitation to make further submissions.

7. Without prejudice to the generality of the foregoing, the following specific rules shall apply to the following situations: -

(a) Post

Representations sent to the Commission by post shall be deemed to have been received by the Commission at the time when they were delivered by An Post to the offices of the Commission for Aviation Regulation at 3rd Floor, Alexandra House, Earlsfort Terrace, Dublin 2. In the event of any disagreement as to this time, the time at which the Commission received the representations will be deemed to be the time at which they are delivered by An Post unless the party sending the representations can prove otherwise.

(b) Courier or Hand Delivery

Representations sent to the Commission by courier or hand delivery shall be deemed to have been received by the Commission at the time when they were delivered by the courier company or the person effecting hand delivery to the offices of the Commission for Aviation Regulation at 3rd Floor, Alexandra House, Earlsfort Terrace, Dublin 2. In the event of any disagreement as to this time, the time at which the Commission received the representations will be deemed to be the time at which they were delivered by the courier company or the person effecting hand delivery unless the party sending the representations can prove otherwise.

(c) Fax

The Commission will be deemed to have received representations sent by fax at the time of receipt by the Commission of the last page of the fax transmission containing the representations. In the event that the Commission starts to receive a fax transmission prior to the deadline and the fax transmission is not completed until after the deadline, the Commission will only be deemed to have received that portion of the transmission sent on or before the deadline.

(d) Electronic Mail

The Commission will be deemed to have received representations sent by electronic mail at the time when the electronic mail containing the representations enters the information system, which the Commission has designated for the purpose of receiving electronic communications. In this case the information system represented by the electronic mailing address info@aviationreg.ie is the information system that the Commission has designated for the purpose of receiving electronic communications. No other address of the Commission or its staff should be used.

8. Delivery of Documents

The Commission requests that all written submissions be typed. Submissions sent to the Commission in electronic form either on floppy disk or by e-mail to info@aviationreg.ie should be either in Microsoft Word (".doc") or portable document format ("pdf").

In all cases the sender shall have an obligation to ensure that the information is actually received by the Commission on or before the specified deadline.

9. Information

Having regard to the principles of better regulation, the Commission is concerned to ensure that the process leading to its determination is administered in an open, accessible manner. This is reinforced by the requirements contained in Section 5(4) of the Act that the Commission ensure that its determinations and requests be objectively justified, non-discriminatory, proportionate and transparent. To that end, details of all statutory requests for information by the Commission will be posted on its website.

DAA will be the source of much of the information that will be needed by the Commission to make a determination. It is vital that all interested parties, as well as the public, have sight of all relevant information (subject to the requirements of confidentiality) relied upon by the Commission for the purpose of its determination, otherwise their ability to fully participate in both the initial consultation as well as the statutory consultation could be impeded.

While parties are free to designate part or all of their submissions as confidential (and should do so clearly, as is their obligation) this has the potential to create difficulties for the Commission. If the Commission is to make available the information leading to its determination, then all of the information upon which it relies for the purpose of its determination should, as a general rule, be put into the public domain. As a result, the Commission proposes to counteract any information asymmetry, which may otherwise arise in the following manner:

10. Confidential Information

The Commission acknowledges that circumstances may arise where the disclosure of highly sensitive confidential information may cause damage to the party supplying the information. Clearly, the Commission will have access to and will analyse all relevant information, but it is also desirable that interested parties and the public have access in turn, to information that is relied upon by the Commission for the purpose of its determination. The Commission has a statutory obligation to give reasons for its determination. Consequently, as a general rule, unless the Commission is able to put all of the information that it is relying on into the public domain, it will be reluctant to rely on that information for the purpose of making its determination. Nonetheless, the Commission is of the view that even where information is regarded as highly sensitive by the disclosing party, it may be possible, whether by means of aggregation or otherwise, to disclose the information in a modified manner. Where justified, the process of aggregation or restatement will be performed by the disclosing party in consultation with the Commission after the Commission has seen all of the information in original form.

11. Use of the Commission's website

As indicated, the Commission proposes to place all of the submissions and representations that it receives in response to requests, on its website. Ordinarily, the Commission will not be editing this material. As a result, the content of any submission is solely a matter for the submitting party, and in that regard, interested parties are referred to the legal notice and indemnity concerning use of the Commission's website which is contained in Annex I to this paper.

LEGAL NOTICE

While 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.

INDEMNITY

Any party submitting information to the Commission in response to a document inviting submissions acknowledges that the Commission intends to publish that information on the website of the Commission, in reports of the Commission and elsewhere as required or appropriate. Parties submitting such information to the Commission consent to such publication. Any party submitting information to the Commission shall have sole responsibility for the contents of such information and shall indemnify the Commission in relation to any loss or damage of whatsoever nature and howsoever arising suffered by the Commission as a result of publication or dissemination of such information either on its website, in its reports or elsewhere.

Annex 2

Preparation & Evaluation of Dublin Airport Traffic Forecasts, Mott MacDonald, May 2005.

Annex 3

Assessment of the 2003/04 Handling Capacity of Dublin Airport, William Hynes & Associates Ltd, May 2005.

Annex 4

Dublin Airport bottom-up efficiency study Booz Allen Hamilton April 2005

Annex 5

Dublin Airport Authority's Cost of Capital, Colm Kearney & Elaine Hutson, May 2005

Annex 6

Dublin Airport Assessment of commercial revenue 2005-2014, Alan Stratford & Associates, May 2005.

Annex 7

Dublin Airport Authority Capital Investment Programme 2005-2014,
DAA CIP 03 May 2005

Annex 8

The Cost of Capital for the DAA, A Final Report for the DAA, NERA Economic Consultants April 2005.

Annex 9

Dublin Airport Passenger & Aircraft Movements Demand Forecast Report March 2005

Annex 10

Indicative price cap tables.

Annex 11

The Performance of Dublin Airport: The findings of the Comparative Reports of the TRL and the ATRS.

Annex 12

Dublin Airport Authority Passenger Survey.