

## **Response to the Issues Paper CP7/2018**

Please find below Ryanair's comments on the Commission Paper CP7/2018 entitled *Issues Paper 2019 Determination of the Maximum level of Airport Charges at Dublin Airport* (the "Issues Paper").

### **Policy Developments**

The most significant developments are the proposed changes to the policy objectives as set out in the 2017 National Policy Statement on Airport Charges Regulation. Although the timing of the legislation to implement these changes remains unclear, CAR should nevertheless take account of the objectives contained in the National Policy Statement. Notably, the specific requirement for CAR to have regard to the financial viability of daa is proposed for removal, as is the ability of the Minister to issue Ministerial Directions. The removal of these two provisions is to be welcomed as adherence to these had an undue negative influence on past Determinations, to the detriment of customers.

### **Approach to Regulation**

The requirement for economic regulation of Dublin Airport is due to the fact that Dublin Airport enjoys significant market power. This has been confirmed on numerous occasions, notably by CAR in its submission to the Consultation on the Review of Airport Charges Regulation in Ireland, where it stated that "*the dominant position of Dublin Airport is evident using any sensible measure of market power and any reasonable definition of the market. This market power, if left unchecked and unregulated, would result in a significant loss of consumer welfare.*" In addition, Indecon's *Review of the Regulatory Regime for Airport Charges* also confirmed that "*Dublin Airport is the only airport in Ireland which is deemed to hold significant market power and as a result continued economic regulation is recommended.*"

The current building block Regulatory Asset Base (RAB) approach should be retained provided that the daa engages constructively with airport users on the various blocks, namely capex, opex, WACC and commercial revenues, and reflects airport users' input in its submissions to CAR. RAB-based regulation provides a degree of continuity and stability and should provide airport users with protection against excessive pricing, whilst giving the regulated firm incentives to deliver cost efficiency improvements.

Furthermore, CAR should continue to apply the single till approach, as per Indecon's recommendations, given that single till reflects the pricing mechanism that airports would apply if they were subject to competition.

Nevertheless, CAR should remain aware of potential pitfalls the current approach. For example, the building blocks approach could incentivise daa to "game" the regulatory system, namely by over-estimating the capex it claims is required. In order to avoid such a situation, it is imperative that CAR requires the daa to engage constructively with airport users, and reflect their input in its submissions to CAR. This is also consistent with the Thessaloniki Forum's recommendations on Consultation and Transparency.

Finally, it may be worthwhile considering whether the regulatory regime should include the use of sub price caps (e.g., relating to efficiency / cost of airline requirements / behaviours) rather than a single overall price cap as is the current approach.

### **Duration of price caps**

The current five year period duration for setting price caps is generally a reasonable period over which to forecast costs and revenues. In addition, the availability of a supplementary capex allowance procedure allows daa to incur capex with a guarantee of a return on capex if such capex is so required by its customers. On balance, therefore, we believe that the current 5 year period is reasonable.

### **Passenger Forecasts**

Although passenger forecasts are forward-looking, and therefore uncertain, daa has a number of methods it could use to forecast passenger traffic. It could for example extrapolate recent growth trends in order to forecast future trends and, given the close correlation between airport charges and passenger traffic, it should also ask airlines to forecast their passenger traffic based on a number of airport charges scenarios. This should allow for an approximation of passenger traffic on the basis of different scenarios.

### **Risk**

CAR has previously stated that "*A guiding principle in past determinations has been that the DAA should bear those risks that it is best able to control. For example, it bears the risks associated with cost outturns deviating from those forecast at the time of a determination.*"<sup>1</sup> This remains the case, and Dublin Airport should assume all the risks that outturns deviate from the numbers assumed in the building-block calculations, as this is the principle on which incentive-based regulation is founded.

Responsibility for volume risk should remain with daa as it has ability to stimulate growth through reductions in airport charges and / or the introduction and long-term retention of appropriate

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<sup>1</sup> Maximum Level of Airport Charges at Dublin Airport, Commission for Aviation Regulation CP2/2013, page 12.

incentives. When external shocks occur, airlines can reduce fares to stimulate passenger throughput, which mitigates the risk to airports but may require airports to reduce airport charges temporarily. To the extent that residual risk remains with the airport, it can be compensated for by the airport reducing opex. In any event, airports are better placed to bear volume risk than airlines, given the nature of their business. Risk is also factored into the regulatory model through the choice of an appropriate WACC.

In the event of a shortfall in traffic vis-à-vis passenger forecasts, it would be counterproductive for the airlines to take on the risk through higher charges as this would create a perverse incentive to reduce traffic still further. If the reason for the shortfall is general economic conditions, it is likely that airfares will have been reduced in an attempt to stimulate demand, making any increase in charges in such circumstances doubly unfair. If traffic grows more than expected, airlines would expect that any excess returns to the regulated entity be returned to customers at the next determination.

### **Operating Expenditure**

In order to efficiently estimate daa's required opex, CAR must first establish how efficient daa currently is. The scope for improvements in existing productivity levels appear to be greater than CAR has previously assumed. Steer Davies Gleave (SDG), in its report for CAR, noted numerous areas where efficiency could be improved, mainly in staff costs.

As noted in paragraphs 6.6 and 6.7 of the Issues Paper, the assumed inelastic response of opex to passenger numbers has not materialised. In other words, economies of scale have not materialised as would have been expected and opex has increased at Dublin Airport at a greater rate, relative to passenger growth, than was assumed. In fact, overall opex increased at an elasticity to pax growth of 0.68 rather than the predicted 0.16.

CAR notes in paragraph 6.11 of the Issues Paper that the biggest factor leading to the increase in opex in recent years has been staff costs, which accounted for about 70% of the deviation in 2016. This is clearly where the Airport's opex inefficiencies predominantly lie. In its report to CAR, SDG identified a number of areas where DAA could improve efficiency and a number of these involved changes to working conditions and practices. Outsourcing was suggested as one way of addressing this, as was addressing the high salary levels for legacy staff. Clearly, Dublin Airport has made insufficient progress in this.

In Ryanair's response to CAR on the 2013 Draft Determination, it pointed out a number of issues relating to opex efficiency including:

- Opex being 10% higher than the average of other Ryanair destination airports;
- the crude assumption by CAR of taking a halfway point between the high ambition and low ambition opex assumptions put forward by SDG failing to take account of the scope for increase efficiency;
- Dublin Airport staff salaries are substantially above the Irish national averages;

- staff numbers for ‘campus services’ were excessive and other airports had demonstrated that reductions are possible;

Given the excessive level of opex in the first years of the current regulatory period, it would appear that Dublin Airport has not made any headway in addressing these issues in any substantive way. There is no case for risk sharing in this area. daa should be able to control its own costs and it alone should carry the risks of not doing so.

In terms of forecasting methodology, CAR should use a combination of bottom up analysis and benchmarking. With regard to opex elasticities, CAR should look at what is achieved at other comparable airports, both now and over time. The benchmark airports should include those with a high proportion of low fares airline traffic as well as other secondary hub airports rather than exclusively the main national airport in each comparator country. In any event, CAR should set ambitious targets for Dublin Airport in achieving greater opex efficiencies.

Finally, rolling incentives would only be effective if Dublin Airport was operating at or close to the efficiency frontier. As this is clearly not the case, there is no reason to allow Dublin Airport to retain savings for a longer period that should have been implemented earlier. There is no reason to change this view at the current time. This is a clear example of the introduction of rolling schemes dampening the efficiency incentive of regulation.

## **Commercial Revenues**

There has been very significant growth in commercial revenues at Dublin Airport between 2014 and 2017, amounting to 13.5% average real growth over the period, and also growth in revenue per passenger<sup>2</sup>.

In its 2014 Determination, CAR estimated various elasticities between passenger growth and commercial revenues, using econometric modelling of historic trends. This kind of modelling has some value but it is also, by its nature, backward looking, using as it does analysis of historic trends. When used in isolation, this does not take into account the fact that the Dublin Airport could have been underperforming in the past, and therefore carries forward any such underperformances into future projections.

As part of future benchmarking exercises, it would be advisable for CAR to look not only at revenue per passenger at a particular point, but also the ability of comparable airports to grow revenue per passenger over time and to take explicit account of any changes to the layout and range of facilities offered.

When examining whether to allow revenue-generating capex schemes into the RAB, CAR should examine their real potential for increased revenue generation and then hold the Airport to account if the additional revenues are not achieved. CAR should continue to have regard to the interaction between commercial revenue and other building blocks, particularly in terms of ensuring that any additional opex or capex delivers targeted increases in revenue.

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<sup>2</sup> CAR Issues Paper 7/2018, paragraphs 7.3 and 7.9.

CAR raises the possible impact of future events in its Issues Paper. With regard to the impact of trends in the retail industry, e-commerce should open new possibilities for airport retail. Dublin Airport has a captive market passing through its terminals, and should fully exploit innovative online options for sales and marketing of airport retail offers.

In order to forecast commercial revenues, the use of econometric modelling should be supplemented by benchmarking and by ‘bottom up’ analysis. Benchmarking should not only consider a snapshot of other airports’ performance but should also look at what other airports can achieve over time; in other words, the rate at which performance might be able to improve.

CAR should review areas where the definition of “commercial services” encompasses what are effectively monopoly airport services, such as Access to Installations. Dublin Airport is incentivised by the regulatory approach to maximise revenue from these sources. Dublin Airport’s argument that the amounts involved are *de minimis* is not a good reason to ignore them and it is wrong to assume that the cost of maintaining regulatory supervision and intervention in this area would outweigh the benefits.

Rolling schemes should not be used, as they would only offer benefits if Dublin Airport were at or close to the forefront of what is possible in terms of maximizing commercial revenues, which is clearly not the case at the current time. Otherwise, rolling schemes allow the Airport to retain the benefits of improvements for longer than it should, when the scope for improvement is already evident for some time. The way in which actual commercial revenues have significantly outperformed forecasts in the first part of the current period bears this out.

### **Capital Expenditure**

As CAR is aware from Ryanair’s previous correspondence, the daa’s “consultations” have regularly been no more than untransparent box-ticking exercises in which daa ignores users’ input. In order to avoid a repeat of this, CAR should require daa to constructively engage with airport users, and to justify and agree with airport users all capital expenditure items that could affect airport charges. In the context of such constructive engagement, daa’s capex expenditure could be benchmarked against competitive airports, which would ensure that daa’s capex is both required by airport users and efficiently incurred. CAR should only permit daa to undertake capex if it can prove that such expenditure is required, efficient and a result of constructive engagement with users. In this regard, CAR should implement the recommendations of the Thessaloniki Forum on Consultation and Transparency.

In addition, the principles set out in Table 8.2 in relation to under or over-spends appear reasonable, albeit, in the scenario that an investment is abandoned, all capex should be clawed back unless airport users agreed with the decision to abandon the investment.

The principle of 50/50 “risk-sharing” of capex should not be considered for allowances in the 2019 Determination. This principle does not exist in competitive markets, and could lead to regulatory gaming that results in over-specification and excessive prices for airport users and consumers.

Airports that operate in competitive markets are incentivised to incur capex on a cost efficient basis as this leads to lower airport charges and rewards airports through passenger growth and increased non-aeronautical revenues. On the contrary, a 50/50 “risk-sharing” mechanism, would allow daa to recover from users 50% of its inefficient expenditure and charge monopoly profit on it in order to fund the other 50% that in theory is a daa risk. In practice, there is no risk for the daa in this arrangement: it either spends less than the regulatory capex allowance and recovers from users 50% of the money it did not spend, or it spends more than the regulatory allowance and charges a monopoly profit on 50% of this overspend.

## **Cost of Capital**

In terms of Cost of Debt, we are concerned that the methodology used by CAR in the 2014 Determination runs the risk of double counting the effect of the risk-free rate because the risk-free rate is used both in the cost of debt and in the cost of equity. A change in the risk-free rate would make the cost of capital even more sensitive than should be the case. This can result in excessive volatility in the cost of capital, as has been seen in the fluctuations at Amsterdam Schiphol Airport where the calculated cost of capital has varied over the years 2014-2017 at 4.3%, 2.9%, 1.8%, 2.2%<sup>3</sup> due the 10-year Dutch Government bonds yields dropping. Whilst the cost of capital is fixed for the 5 year regulatory period at Dublin, this volatility generated by the risk-free rate each year runs the risk of an inappropriate cost of capital being set at a fixed point in the regulatory cycle.

Other methodologies used in estimating the cost of debt include: a) using a weighted average of the cost of embedded debt and new debt; b) estimating a fixed rate by using benchmark comparators; and c) debt indexation. Nonetheless, the current methodology, if implemented correctly, is considered appropriate for estimating the cost of debt.

There are three important considerations:

- Estimating the Risk-free rate and Inflation adjustment

CAR has previously estimated the risk-free rate using the 10-year German Government bonds which is in compliance with the Thessaloniki Forum. There are advantages in using German Government Bonds instead of Irish Government Bonds, one being the German Government Bonds, at least on paper, can be considered as a risk-free asset, due to the AAA Rating given to the Government of Germany (the highest rating). In comparison Government of Ireland, currently rated A+, is considered riskier than the German Government and in the same range group as DAA itself (A-). Also, the German Government bond market is a larger and more actively traded market than the Irish Government Bond market, which reduces any liquidity premiums and volatility that would exist. Chart 9.5 of the Issues Paper shows the Real yields on German and Irish Government Bonds in the last 10 years. The chart shows that the real yields on the German Government Bonds have been far less volatile than the real yields on the Irish Government Bonds, which makes it a more appropriate source to use in forecasting the cost of capital and likely to give a more stable

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<sup>3</sup> Schiphol Group Annual Reports 2014-2017

outcome. However, care is needed in relying on German Government bonds as the yields could be subject to German Government Policy influencing the demand and supply of these bonds.

In regards to the conversion of Nominal rates to Real rates using the Fisher Equation, we believe that this methodology is still fit for purpose. However, again, the use of survey data to extract suitable inflation figures, does not seem appropriate. The methodology is only appropriate if account is taken of the actual inflation that occurred in the given year. We also recommend CAR to also take into account the yields on the German Inflation linked Government Bonds to have a holistic view on the real risk-free rates.

- Estimating the Debt Premium

In estimating the debt premium, CAR has used two key sources: daa’s credit rating at the time and the cost of debt of comparator companies. This partly covers the recommendations of the Thessaloniki Forum, but there remain other recommended practices not adopted in 2014. The business model and the cash generating ability of an airport is very unique, even in the infrastructure space, which makes them more attractive to banks, pension funds and other investors. Irrespective of their credit ratings, we have noted that airports raise debt at far lower rates than the comparator “*corporate non-financial bonds issued by a firm with minimum BBB rating and a maturity of 7-10 years*”<sup>4</sup> as used previously by CAR.

The table below demonstrates a sample of recent debt raising activity undertaken by airports across the globe:

Recent Debt raising activity by Airports							
Airport	Year	Credit Rating	Amount (m)	Tenor	Nominal Rate <sup>5</sup>	Real Rate <sup>6</sup>	Notes/References
Heathrow	2017	A-	€ 500	15yr	1.88%	-1.2%	
Heathrow Finance	2017	BB+ (or Ba3)	£275	10yr	3.88%	0.8%	High Yield Subordinate Debt
Amsterdam Schiphol	2017	A+	€ 400	9yr	2%	0.8%	Euro Mid-Term Note Programme
Sydney Airport	2018	Baa1 (or BBB+)	€ 500	10yr	1.75%	-0.1%	International Securities Identification Number: XS1811198701
Hyderabad	2017	BB+	\$350	10yr	4.25%	-0.2%	Oversubscribed multiple times

<sup>4</sup> Pg.59, Note 9.19, Issues Paper, 2019 Determination of Maximum Airport Charges at Dublin Airport

<sup>5</sup> Inflation rates are specific to the Airport’s country.

<sup>6</sup> The Real Rate is calculated using the inflation rates published for the given year. For bonds raised in 2018, the 2017 inflation rate was used.

It is worth noting that even airports rated below investment grade, such as Hyderabad International Airport, are able to raise debt at a real yield around under 0%. Sydney Airport, rated Baa1, a notch below Dublin Airport, has raised a 500m Eurobond also for under 0% when adjusted to inflation. It is important that CAR takes into account the actual rates, both nominal and real, at which airports (at least in Europe) are currently raising debt capital, as the basis for estimating the debt premium. This would be consistent with the Thessaloniki Forum recommendation that the debt premium should be estimated “*through comparison with other similar rated airports*” rather than a broad corporate investment grade benchmark.

- Debt Indexation and Embedded Debt

We believe debt indexation, on one hand, creates more equity between the consumers and the Airport as the cost of debt would truly reflect the market conditions. However, we agree with CAR’s analysis that debt indexation also provides a weaker incentive to the Airport to manage its debt costs as it guarantees that the Airport would be able to retrieve the debt costs through the building blocks at the market rates at each determination. However, setting a fixed cost of debt would incentivise the Airport in achieving lower debt cost as the Airport keeps the difference if it achieves cost of debt lower than the regulatory cost of debt. Also, the cost of debt benchmark index is constantly changing and may become volatile. In these cases, setting a fixed cost of debt could act as a ceiling to volatile prices and protect consumers from sudden spikes in cost of debt. We believe the cost of debt should, at present, only include the cost of new debt as it could potentially help incentivise the Airport in minimising its cost of debt. Until now, daa has only raised one Eurobond to partly refinance its existing loans. This rate of re-financing is lower than its embedded debt. Hence, the importance of considering current bond rates available in the airport sector. Embedded Debt should only be considered if the Airport is seen to have been actively taking advantage of the low yield debt market and is consistently achieving rates on par or below the market rates. This is because inefficiency in debt management could lead to a higher embedded debt costs being passed on to the consumers, if the embedded debt were to be used in determining the cost of capital.

In terms of Cost of Equity, there are two key components:

- Estimating the Equity Risk Premium

CAR has previously estimated the Equity Risk Premium using the Total Market Returns estimated by Dimson, Marsh and Staunton using long term global historic evidence and then adjusting to CAR’s estimated risk-free rate. We support the use of this data source in principle but we recommend CAR to estimate the market risk premium using data from the “*Annualized equity, bond and currency premia*” graph; in particular, “*EP Bonds and EP Bills*” as “*EP Bonds denotes the equity premium relative to long-term government bonds; EP Bills denotes the equity premium relative to Treasury bills*”<sup>7</sup> and use this relative term to estimate the Equity Market Risk Premium. This takes into account the equity returns over and above the risk-free rate over the longer period

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<sup>7</sup> Pg 47, Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2016



of time and is not subject to the risk of errors inherent in subtracting CAR's estimated risk-free rate from Total Market returns as this may not be comparable or over a comparable time period. Estimating Equity Risk Premium by using long-term Total Market Returns of Irish Equities and adjusting to Risk-free rate estimated using German Government Bonds over a shorter time period, does not yield a clear picture on the Equity Risk Premium as it is mixing two data sources which are not necessarily consistent.

- Estimating Equity & Asset Betas

We believe CAR should strictly follow the Thessaloniki forum recommendations on estimating the Equity and Asset betas as the data sources cited in the Issues paper do not satisfy some of the recommendations. For example, CAR has cited a table from PwC report on the cost of capital for H7 at Heathrow. However, it is worth noting that PwC have used a European Index to estimate the asset beta. We believe this estimate does not comply with the Thessaloniki Forum recommendations as the Forum clearly states that “the market portfolio used to calculate the beta equity should be the national index of the State where the airport is located”<sup>8</sup>.

PwC, in its sensitivity analysis for Fraport and AdP's betas, mentions that “*Using a European Index as opposed to a local index tends to increase the asset beta calculated.*”<sup>9</sup> The European Index includes stocks across the Europe and not just a single country. Estimating a beta value from a stock listed in one country to a European Index does not take into account the volatility that takes place in the national index. CAR, too, has used a ‘global stock market index’<sup>10</sup> in assessing Asset beta of comparator airports instead of regressing against the local index.

We note that the PwC report uses an average asset beta of listed airports across the globe. However, the Thessaloniki forum suggests that “*The sample of peer airports should be restricted to the European Economic Area and Switzerland (EEA). However, if the number is limited it could be extended to countries with a comparable general economy and/or to other relevant sectors, such as the transport infrastructure sector*”. We understand that the sample size of listed European Airports is small, but we still recommend CAR to place a higher weight on listed Airports in the EEA to maintain the relevancy of a European Airport.

The Thessaloniki Forum recommendations also state that “The beta equity of regulated or state-owned airports should generally be low. As a general rule, the risk of a regulated airport should be lower than the market ( $\beta < 1$ )”. We believe this strongly applies to Dublin Airport as the Airport is state owned. We believe CAR should strictly follow this recommendation in estimating the Equity and Asset beta for Dublin Airport.

Overall, our strong recommendation to CAR is to follow the Thessaloniki Forum recommendations and be more cautious in the data sources it uses to estimate the beta, as the methodology involved in some of the estimates may overestimate the Equity beta values. In particular, CAR should take the following steps:

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<sup>8</sup> Appendix 1, Issues Paper, 2019 Determination of Maximum Airport Charges at Dublin Airport

<sup>9</sup> Pg 83, Estimating the cost of Capital for H7. A report prepared for the CAA

<sup>10</sup> Table 9.5, pg. 63, Issues Paper, 2019 Determination of Maximum Airport Charges at Dublin Airport

- Ensure the beta comparators for the listed Airports use a local market index and not a regional/global index.
- Place a higher weighting on betas of Airports listed in the EEA.
- Understand that Dublin Airport's unique position of being state owned and regulated means the risk it faces is lower than the market as a whole.

We recommend that CAR should use the data as a guidance tool and not a decision maker tool, as each airport is unique in the context of business risk.

In our opinion, the notional Gearing assumption of 50:50 Debt-to-Equity is appropriate in the context of a notional airport and not far off from DAA's current capital structure. The risk and the need to change the assumption only arises when the Airport's capital structure mix changes extremely towards either one direction. For example, firms may take advantage of the lower interest rates and may choose debt financing over equity financing to fund large capital expenditures. However, as noted earlier, the regulatory WACC set prior to this regulatory period did not take into account of the change in the cost of debt over time. This results in a position where the Airport benefits from the drop in interest rates and also benefits from the higher cost of debt assumed in the regulatory WACC, resulting in charges being higher than they might otherwise be. Should the capital structure change, in particular to finance expansion, CAR may need to adjust its Gearing assumption.

### **Quality of Service**

In overall terms, the balance of Quality of Service targets should overwhelmingly be towards those which can be objectively measured. Whilst the ACI survey, upon which the current passenger satisfaction measures are based, allows relative benchmarking of performance, it is not targeted specifically enough to measure actual quality of service at any particular airport. In particular, it is not clear if the qualitative passenger responses are weighted to reflect the quality of service offered in the peak or may be unduly skewed towards off-peak conditions. Indeed, the weighting of the results is not clear, notwithstanding that the survey is claimed to be based on a robust sampling framework. It should be Dublin Airport's responsibility to ensure robust data collection of both arriving and departing passengers to the extent that it seeks to rely on these surveys as a basis for charging airlines up to the full price cap.

Quality of service should be consistent across the two terminals where airlines are competing, e.g. in the European short haul sector. Any customisation between terminals should not distort airline competition and be applied only where there are distinct sectors of traffic with different level of service requirements, e.g. US Pre-clearance.

Furthermore, the ease with which Dublin Airport has been able to meet its quality of service targets suggests that there is scope for increasing the amount of revenue at risk (e.g. to 7%, as at Heathrow

and Gatwick) to the extent that there remain shortcomings in the level of service which are material to the efficiency of the service provided to airlines and their passengers.

### **Other Issues**

daa's yearly request to CAR to net off "*traffic / route incentive schemes*" from its airport charges revenues has no basis in legislation or the 2014 Determination, and in effect gives daa certainty that it can reclaim incentives from users 2 years after granting them (during which time daa benefits from the incentives in the form of traffic growth and increased commercial revenues). The correct way of treating incentive schemes would be for daa to consider them as non-recoverable opex. This is consistent with the behaviour of airports that operate in competitive markets that do not benefit from any automatic entitlement to claw back incentives, and instead stimulate traffic growth through incentives, with the benefits of additional traffic derived from the economies of scale and commercial revenue. CAR should therefore prevent daa from any future claw back of incentives.