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Commission for Aviation Regulation  
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Sept 16, 2022

Re: Draft Decision on Interim Review of the 2019 Determination in relation to 2023 to 2026

Dear Adrian,

Following publication by the Commission for Aviation (CAR) of its Draft Decision as part of the full building block review, Aer Lingus would like to raise several issues for your consideration in advance of the issuance of the Final Decision in the coming weeks.

## 1. Passenger Forecast

Aer Lingus notes the CAR's approach in respect of the traffic forecast underpinning the Draft Decision and that also note that its Final Decision will take account of the actual traffic data for the summer and the autumn.

Whilst Aer Lingus broadly agrees with the approach, we believe that the 2022 forecast is understated and that a revised baseline provides further upside over the course of the regulatory period.

Aer Lingus' Dublin load factors for both long-haul and short-haul continue to rapidly recover and were on par with 2019 over the summer period. Bookings for travel in the coming autumn and winter show continued robustness.

Aer Lingus has seen a rapid recovery in passenger demand in summer 2022 particularly in leisure markets. In this regard, we would make the following observations:

- Strong transatlantic demand set to continue following the removal of Covid testing requirement for travel to and from North America on 12<sup>th</sup> June 2022.
- By August 2022, our Dublin seat capacity will be at 84% of August 2019 levels (83% in shorthaul, 88% in longhaul).
- Capacity would have been higher if not for constraints on aircraft reactivation and recruitment/training of crew and ground staff.

- Despite the positive growth, our capacity and passenger numbers have been impacted by capacity restrictions at airports:
  - This has resulted in cancellations in the key markets of London Heathrow and Amsterdam in particular and will understate peak 2022 traffic in these markets. These restrictions are not expected to continue through 2023.
  - It has also impacted same day business travel on UK and near Europe markets where customers on short day trips are put off travelling due to airport congestion.
- Our Dublin capacity will grow in 2023-2026 as we backfill fleet cuts made during Covid and take delivery of new previously contracted aircraft.
- Published schedules show that other airlines' (OAL) summer 2022 Dublin capacity is above 2019 levels in shorthaul and only moderately below in longhaul. Specifically:
  - OAL shorthaul seats are at over 100% of Summer 2019
  - Ryanair has already fully recovered their 2019 capacity. Their published Winter capacity is 9% ahead of 2019
  - OAL longhaul seats are at 91% of Summer 2019 (97% for DUB-North America, despite exit of Norwegian)
- A number of transient factors weighed on 2022 demand that will likely not be repeated in 2023. In particular:
  - Dublin capacity has been limited for some years by runway availability which will no longer be the case in summer 23 with the opening of the North Runway
  - Northern Europeans displayed a strong preference for sun holidays in 2022 (due to being unable to take one in the previous two years). Inbound demand in Ireland suffered as a result but this will likely revert to trend in 2023.
  - The Ukraine crisis led to a shortage of accommodation in Ireland, particularly in rural areas popular with inbound leisure traffic, depressing Point of Sale Europe demand
- No evidence of structural demand change coupled with signs of strong competitor growth at Dublin in 2023 and beyond including:
  - Ryanair fleet growth and renewal with higher capacity 737MAX aircraft
  - New transatlantic entrants as evidenced by Norse slot filings at Dublin
  - Reopening of Asia markets
- Aer Lingus capacity is projected to exceed 2019 levels by 2024, and our shorthaul competitors are on course for faster growth
- Airlines' revenue management strategies mean that this capacity will likely be absorbed and firm fleet growth means that it will likely be sustained.

## 2. Opex

Aer Lingus has reviewed the Opex assumptions and is supportive of the CEPA assessment in the Draft Decision. We would also highlight the following issues for consideration in advance of the Final Decision.

- CAR's passenger forecast understates expected traffic growth
- A small number of issues remain on cost efficiency
- There is little evidence that Dublin Airport's sustainability plan, including both its Opex and Capex, has been developed in a cost efficient manner to meet mandatory targets

### Passenger forecast

Our comments on CAR's passenger forecast have already been detailed above. In summary, Aer Lingus assesses that the passenger forecast for the determination period (30.1m pax in 2023 increasing to 35.2m in 2026) is understated. We would encourage CAR to use a higher assumed level of passenger traffic for its Final Decision, based on more reasonable industry estimates of the post Covid recovery path at Dublin Airport. This would provide a more robust baseline and allow cost efficiencies to be leveraged across a larger number of passengers.

### Cost efficiencies

Although we welcome the work of CAR's consultants, we have a number of remaining concerns regarding Dublin Airport's operating expenditure proposals.

Before commenting in more detail on CAR's assumed operating expenditure in the Draft Decision, we would like to acknowledge the work done by CAR's consultants, to update its original "2019 study" on cost efficiency at Dublin Airport in support of the 2019 Determination. CAR originally commissioned CEPA/Taylor Airey to undertake a bottom-up efficiency assessment and we believe that the updated report is a robust piece of analysis and helpful to the overall review process. We agree with CAR that productivity improvements incorporated into its staffing and cost forecasting are achievable.

While CAR appears to have mostly adopted its consultants' projections in the Draft Decision, there are several areas of concern that should be addressed before CAR issues its Final Decision as follows:

- *Pre-2010 contracts* – We understand that the VSS and restructuring implemented by Dublin Airport during Covid has resulted in a materially lower number of staff on pre-2010 contracts. In 2022 there are now approximately 690 staff on pre-2010 contracts, which is approximately 27% of all staff (compared to 40% in 2017). The reductions have been relatively higher in the frontline areas, particularly Security and Campus Services, which will enable greater flexibility and improved productivity. While CEPA/Taylor Airey confirm that these changes

have been reflected in its future projections, it is not clear what the net employment cost benefits of the new contracts are and there is no indication that further reductions and indeed efficiencies, through natural attrition rates of the remaining pre-2010 contract staff, has been assumed in forecasts.

- *Assumed baseline* – We note that there are several areas where CEPA/Taylor Airey has lacked sufficient evidence to substantiate Dublin Airport’s assumptions and yet has adopted their numbers as a baseline, albeit subject to further review and validation. Some examples include: the efficiency of rosters; an increase in the throughput rate post Covid as being permanent; and staff training to be rostered in thereby increasing the overall staffing requirement. The industry is experiencing unprecedented levels of disruption and uncertainty that is leading to temporary inefficiencies in the way passengers are handled through airports and leading to a lack of preparedness from passengers and understanding of what is expected of them as they navigate their way through airports. We believe that CAR needs to take a robust approach to these issues and ensure that underlying and/or temporary inefficiencies are not consolidated into the assumed baseline for future projections.
- *Roster efficiency* – We note that CEPA/Taylor Airey’s 2019 study identified an efficiency gap with security rosters and yet the 2019 rosters have been assumed to be efficient for the purposes of forecasting staff numbers in CAR’s Draft Decision. We agree with CEPA/Taylor Airey that the changes in staffing levels and terms and conditions since 2019 should provide a basis for closing this efficiency gap. If Dublin Airport does not provide the roster information required for the the CAR’s consultants’ analysis to be updated, we believe that CAR should in any case make reasonable assumptions on a realistically achievable staff reduction. We also note that the 2019 baseline has been increased to allow for training time to be rostered for security staff to be taken offline. While the increased focus on training to improve efficiency is supported, we do not believe that this is required on a permanent basis and believe that there are innovative ways of providing the required training within shift times.

- *Security lane efficiencies* – We note that Dublin Airport uses a higher elasticity than CEPA/Taylor Airey to forecast security staff numbers at both T1 and T2. All airports are having to reassess the way in which they manage passengers through security lanes and we are seeing innovative approaches across Europe, (for example at Gatwick where the combination of staff communication, new technology and process change is facilitating faster passenger and tray throughput). We are also concerned that Dublin Airport has identified a need for additional lane security staff (+15) to cope with the introduction of C3 scanning and that tray throughput reduces, assumptions that CEPA/TA has adopted. This contradicts our understanding of how this technology will be introduced and indeed contrasts with the experience at other airports<sup>1</sup>. Specifically, that false rejections will reduce and thereby increase throughput. Finally, we note that a further 49 security staff are included by CEPA/TA to cover supervisory roles, an Ops Centre and a testing team. Again, we firmly believe that CAR should take a more robust approach to the proposed scaling up of staff requirements by Dublin Airport and, once the evidence has been reviewed, follow the recommendation of its consultants.

### 3. Capital Projects & Sustainability

Aer Lingus has a number of concerns in respect of Dublin Airport's CIP that remain following publication of CAR's Draft Decision.

In summary, it is our view that the proposed CIP will:

- **Delay** the significant economic benefits of developing a functioning hub at Dublin
- **Increase inefficiency** at the airport with a lack of operational stands at the airport
- **Constrain** the growth in traffic which justifies the proposed CIP

Therefore, whilst we recognise CAR's position that it is for the users and Dublin Airport to come to an agreement on the timing of the infrastructure, the revised delivery timelines for *key* hub infrastructure are not acceptable to Aer Lingus.

The airport must provide timely infrastructure that facilitates the business models of its airlines and supports Ireland's National Aviation Policy. At present, this is not reflected in the current proposals. This serves to highlight the acute need for CAR to include further incentivisation mechanisms for timely infrastructure delivery within the Determination.

#### **Delayed economic benefits for Ireland**

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<sup>1</sup> <https://blog.aci.aero/the-last-piece-of-the-puzzle-ct-scanners-at-security-checkpoints/>

The revised timescales in the CIP will delay the development of an efficient hub operation at Dublin airport and will reduce the significant economic benefits that such a hub would bring to the national economy.

Whilst Dublin Airport recognise their role in promoting the National Aviation Policy, the proposed timelines indicate that it will take at least 15 years to deliver its objectives and address the hub infrastructure deficit from the date that this requirement was first acknowledged by Dublin Airport in 2017. The development of an efficient hub is a key element of National Aviation Policy and delivers significant benefits for the national economy and the vital trade links between Ireland and North America.

The delay to the development of the South Apron infrastructure means that:

- An effective and efficient hub operation will not occur until the 2030s
- Dublin Airport will lose its competitive position relative to other transatlantic hubs
- The economic benefits it provides to Ireland will be delayed and potentially reduced should traffic relocate elsewhere

This is of national concern given the scale of economic benefits of the Dublin hub for Ireland – including more than 30,000 new jobs and additional €20-25bn to the Irish economy over 15 years.<sup>2</sup> This delay to the realisation of an efficient hub risks Ireland losing these considerable benefits should aircraft need to be deployed elsewhere in the event that operational stands and infrastructure are not available at Dublin Airport.

Dublin Airport needs to consider alternatives to allow access for the small number of integrator traffic that currently uses the West Apron rather than delaying the development of the South Apron infrastructure. It is only with the development of stands in the South Apron to establish the Dublin hub can the scale of benefits to the Irish economy be realised.

## **A less efficient airport**

Delays to the development of the South Apron hub infrastructure constrains the airport's operational efficiency, while accelerated construction of the West Apron Underpass is premature.

The major issue at Dublin Airport is the lack of east side stands to accommodate the volume of flights, an issue that will be exacerbated by the operation of the new northern runway. Our analysis shows that:

- Customs and Border Protection (US pre-clearance) capacity will constrain transatlantic traffic volumes **next year**
- There will be **insufficient stands** to accommodate Summer Season peak-day traffic by 2026 – West Apron stands cannot be used for operational aircraft.

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<sup>2</sup> EY-DKM. Economic Impact of the Development of Dublin Airport as a Hub. 7 September 2018. Available from: <https://mediacentre.aerlingus.com/pressrelease/details/108/10102>

- The hub operation will become **unmanageable and uncompetitive** if Aer Lingus aircraft are spread across the airport should stands in proximity to the South Apron be unavailable.
- The South Apron development must be completed by the end of 2027 if the Dublin hub is able to be optimised and deliver the economic benefits

The airport is proposing to prioritise the building of a West Apron Underpass having recently submitted a planning permission application to link the east and the west sides of the airport, rather than the South Apron development that will deliver the Dublin Airport hub.

However, Dublin Airport has the vast majority of its operation on the eastern side of the airport where the current terminal facilities are located. The Western side of the airport has no terminal facilities and is used as a parking area for aircraft. An underpass to the West Apron will add no efficient additional operational stands, lacking the passenger terminal facilities, and thus cannot be used for operational aircraft in contrast to the east side of the airport. Airlines rely on quick turnarounds and on the seamless movement of their passengers through the airport with minimum delays to maintain an efficient operation. Furthermore, it is crucial that hub carriers are in close proximity to neighbouring stands and the US pre-clearance facility to facilitate efficient passenger and baggage transfers.

Furthermore, Dublin Airport's Masterplan suggests that the existing terminals must be fully developed before exploiting other areas of the airport. A key feature of the 55mppa Masterplan includes "maximising utilisation of existing infrastructure" through "development of the existing airport terminals"<sup>3</sup> - the development of a West Apron Underpass before the South Apron development contradicts the approach outlined in the Masterplan.

Whilst Aer Lingus recognise the need for future development of the West Apron to accommodate growth at the airport, this needs to be considered as part of an agreed long term plan for Dublin Airport and after the eastern side of the airport is fully developed which is not the case today. The South Apron infrastructure development, which Aer Lingus supports, will increase stand capacity and facilitate hubbing operations through the expansion of the pre-clearance facility and the development of Pier 5. It is only after full development of the eastern side of the airport that the West Apron can be developed.

## **Constraining traffic growth at Dublin**

Passenger and traffic volumes will exceed the capacity of Customs and Border Protection by 2023 and the East Stands by 2026. This will hold back growth at Dublin Airport and, by extension, the benefits of Irish aviation to the wider economy.

The National Aviation Policy targets the development of Dublin Airport as a vibrant secondary hub, competing effectively with the UK and other European airports. However, hub operations can only grow if carriers are able to add incremental flights at specific times of the day i.e. to meet connecting flights. An Aer Lingus commissioned peak-day analysis, which was undertaken by PA Consulting, indicates that it will not be possible for either Aer Lingus or its alliance partners to add incremental aircraft at those specific times of the day by 2026.

This has implications for the competitiveness of Irish aviation. For example, if airlines are denied growth to reach the required competitive critical mass due to airport constraints at their home base, they will have to consider investing in alternative bases to locate their aircraft rather than at its home base. Alternatively, the airport's hub airlines may lose passengers to carriers connecting via other airports.

When Dublin Airport fails to provide enough operationally acceptable stands for its aircraft, carriers are forced to deploy its aircraft elsewhere. This is not acceptable to Aer Lingus which has aircraft on order to support its transatlantic strategy. If these cannot be accommodated at Dublin, they will have to be accommodated in the UK from where they can be operated to the United States by its UK subsidiary, Aer Lingus UK. This is a damaging but unavoidable consequence for Aer Lingus – leading to lower utilisation of Dublin's new infrastructure (which will be recovered from airlines through higher airport charges) and lower hub efficiencies for airlines (increasing airlines' unit costs).

Furthermore, the combination of the failure to provide timely infrastructure on the east side of the airport to address the stand constraints with the disruption involved in building the West Apron Underpass, will deter other carriers from adding services or new carriers entering the market. Together, we estimate that these developments could lead to a loss of 10-15% of passenger volumes at the airport.

## **Recommendations**

Aer Lingus believes that the fundamental issues we have outlined suggest the need for certain mechanisms and incentives concerning the West Apron, stand availability and the introduction of new technology to deliver an efficient Dublin Airport.

Having regard to the above, CAR may wish to consider mechanisms to incentivise Dublin Airport to build the right infrastructure at the right time. Based on our analysis additional mechanisms could be applied to incentivise Dublin Airport to deliver better outcomes for Irish aviation. These mechanisms include:

- *Remove West Apron developments from the RAB* – CAR should exclude part or all of the proposed West Apron development from the RAB until after 2026. The vast majority (>90%) of aircraft movements at DUB are operated by airlines that



require stands on the East side of the airport to be operationally efficient. CAR could therefore decide to exclude the development of the West side of the airport from the RAB to incentivise Dublin Airport to provide stands where they are required during the next pricing period to 2026.

- *Introduce peak hour / week stand availability level requirements* – Our analysis shows that it is stand availability in the peak time of day and year that is constraining growth at Dublin. CAR could therefore set minimum levels of stand availability in the peaks for the East side of the airport to reflect where the demand is. For example, CAR could set both financial incentive and service quality targets for the following: (i) minimum availability of overnight stands on the North and South Aprons; and (ii) minimum availability of stands for the Summer peak for each year, which could be phased and have a compliance value. Targets are used for such critical infrastructure at other European airports.
- *Incentivise the application of new technology to reduce infrastructure footprint* – there have been a number of technology developments over the past three years which are not reflected in the Dublin Airport proposals. The introduction of new screening technology could for example reduce the footprint of the expanded pre-clearance facility and allow screening for North American flights to take place in the central search area. This would not only reduce the impact on stand availability from the pre-clearance expansion proposals but also improve the efficiency of passenger flow management and double handling within Terminal 2.

## **South Apron**

Aer Lingus welcomes the capacity proposals supporting the development of the South Apron, in particular:

- CIP 20.03.029 New Pier 5 (T2 and CBP enabled)
- CIP 20.03.030 Expansion of US pre-clearance facilities
- CIP 20.03.031 South Apron Expansion (remote stands, taxiway and Apron)

Aer Lingus restates its support for hub enabling proposals within the CIP including the construction of a new Pier 5 in the South Apron. The development of such a pier will help achieve the objective of developing Dublin Airport as an international hub, enable efficient transfer of passengers and baggage and support optimisation of the wider South Apron infrastructure.

In relation to the CBP/TSA expansion, in 2019, Aer Lingus endorsed the commitment made by Dublin Airport to explore technology solutions in order to minimise the CBP infrastructure build requirement. However, Aer Lingus sees no evidence of Dublin Airport's intention to develop and apply any new technology within this revised proposal. Aer Lingus requests that the Commission give due consideration to an efficiency dimension to the existing project governance.

The CIP proposals indicate that most capacity infrastructure delivery and construction works would not take place in the lifetime of this regulatory period even though it is proposed (subject to the relevant legislation being adopted) to extend it for two additional years out to 2026 consistent with the duration of the pandemic.

The delivery timelines proposed by Dublin Airport are wholly unacceptable and will result in Dublin Airport being unable to meet expected demand.

It is therefore necessary that consideration be given by the Commission to appropriate mechanisms that incentivise Dublin Airport to deliver the infrastructure within acceptable timeframes. Specifically, it is our firm view that the South Apron Infrastructure should be delivered by 2027.

## **Incentive Mechanism**

Separate to our observations on financeability outlined later in this document, Aer Lingus welcomes the approach proposed by CAR to incentivise delivery of the South Apron and North Apron infrastructure through a prefunding incentive mechanism:

*“–That is, 80% of the remuneration commences the year after the project has received full planning permission and the main construction is on site, with the remainder once the project is in operational use.”*

While such prefunding of capital infrastructure is a significant departure from the CAR’s normal practice, we believe that this approach is justified in this case as it should and must incentivise Dublin Airport to deliver the critical infrastructure required by the Airport users.

## **Sustainability**

While Dublin Airport’s sustainability-related Capex will be subject to the stage gate process, this does not ensure that major sustainability projects are an efficient way of addressing mandatory sustainability obligations. Furthermore, there is little to no evidence that Dublin Airport’s sustainability plan, including its Opex or Capex, has been developed to meet mandatory targets. Therefore, Aer Lingus cautions against Dublin Airport’s request for accelerated remuneration of sustainability projects. We instead recommend that consideration be given by CAR to enhancing governance processes to help optimise both the decarbonisation and economic benefits of sustainability projects.

Aer Lingus strongly supports initiatives that will help to reduce carbon emissions and increase sustainability. We are working towards the commitments which Ireland has made to reach a legally binding target of net-zero emissions no later than 2050. However, this should not warrant a ‘blank cheque’ for Dublin Airport to accelerate investment at the expense of airlines who also need to finance large decarbonisation programmes. Our

access to finance to launch and sustain such programmes is, in no small part, dependent upon our profitability.

The Dublin Airport CIP includes approximately €360m of investment in assets. On the face of it, the different initiatives being developed by Dublin Airport demonstrate a strong commitment to sustainability which we support. However, it is essential that the investments made are optimised in the interests of all stakeholders and ensure a positive impact on operating expenditure efficiencies. Full transparency is required on the extent to which such initiatives are driven by mandatory sustainability obligations and made in agreement with airlines, versus the airport's own voluntary initiatives which it should fund itself.

It is also not clear whether Capex will focus on initiatives which deliver benefits to both airlines and passengers. For example:

- There is no detailed breakdown of emissions and key emission sources for scopes 1, 2 and 3 within Dublin Airport's proposals.
- There is no breakdown of the investment needed and expected impact on emissions over time for each of the initiatives, e.g. marginal abatement costs
- There is no evidence that Dublin Airport has explored other options or alternatives for each initiative and the numbers behind the business cases (e.g. simple / advanced thermal treatments for waste)
- It is unclear how these initiatives align to forecasted increments / needs related to the different initiatives (forecast of EVs and charging point demand, expected SAF adoption by airlines, etc.)
- It is also unclear how these initiatives are going to benefit airport stakeholders i.e. airlines (apart from through indirect emissions reduction under Scope 3) when measured against alternative initiatives that could provide greater benefit.

#### **4. Cost of Capital**

Aer Lingus has engaged CEPA to advise on the appropriate level of the weighted average cost of capital (WACC).

Aer Lingus welcomes the CAR's Draft Decision which largely rejects the unrealistic proposals and arguments made by Dublin Airport and its advisors regarding updates to the weighted average cost of capital (WACC) applied to calculate Dublin Airport's allowed charges for the period 2023-2026. Nevertheless, we consider that CAR could have gone further to protect passengers' and airlines' interests, specifically:

- Using largely the same methodology that informed the 2019 Determination is likely to result in a WACC figure that overstates Dublin Airport's true cost of capital;

- Methodological choices and their implementation for the Draft Decision – particularly for the asset beta – further increase the gap between the WACC estimate and Dublin Airport’s true cost of capital; and
- There is a case for making a further adjustment to the WACC to protect passengers and airlines from overpaying given the current unusually high inflation environment.

We address each of these in further detail in turn below.

1. The 2019 methodology is likely to overstate Dublin Airport’s cost of capital

Aer Lingus considers that the methodology adopted by Swiss Economics, and accepted by CAR in its 2019 Determination and in the Draft Decision, unreasonably favours Dublin Airport.

- Typically, Swiss Economics derived ranges for components of the WACC by looking at both Eurozone (or German) indicators and Irish indicators. We think this approach risks ending up with a WACC estimate that lacks sound theoretical basis. A preferable approach would be to use Eurozone<sup>4</sup> estimates of components of the WACC. This approach has a sound theoretical and practical basis because investors would typically view Dublin Airport as part of an asset class of Eurozone airport operators; and because Eurozone data provides a larger and richer information source than Ireland-only data. This approach is also supported by regulatory precedent, as it was used by the CRU for PR5.<sup>5</sup> If deemed necessary to account for Irish-specific differences in the expected real cost of capital, an adjustment could be made to account for structural differences in inflation expectations between Ireland and the Eurozone.
- Swiss Economics has used forward curves to uplift the estimates of the risk-free rate and new cost of debt. We do not think that such an uplift is merited – given the low predictive power of forward rates – and that it risks setting an upwardly biased estimate of Dublin Airport’s WACC. For example, the UK’s Competition and Markets Authority (CMA) determined:

*“we consider forward rates do not offer a better assessment of future spot rates than current spot rates. In fact, the evidence suggests that in subsequently flat or falling markets they are likely to give an actively misleading input into any estimate. As such, we now consider that until evidence to the contrary is presented, it would not be appropriate to use forward rate adjustments in our estimates.”<sup>6</sup>*

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<sup>4</sup> Some of which may be German benchmarks.

<sup>5</sup> CRU, Distribution System Operator (DSO) Revenue for 2021-2025, Final Determination Paper, CRU/20/153, 18 December 2020. See chapter 10.

<sup>6</sup> CMA, PR19 price determinations - Final report, paragraph 9.234

Removing this adjustment would reduce the WACC estimate by 18 basis points – the impact would be greater with a lower asset beta as we argue below.

- Swiss Economics has adopted an approach that focuses on a top-down estimate of Total Market Returns (TMR). Both the 2019 report and the current report also discuss a bottom-up approach in which the Equity Risk Premium is estimated directly and added to an estimate of the risk-free rate (RfR+ERP), however this is not given any weight. Given the lack of consensus amongst regulators and finance practitioners as to which approach is preferable, we think it is appropriate to give weight to the RfR+ERP approach and not only to the TMR approach as Swiss Economics has done. There is precedent for doing so: CRU's advisors on PR5 used estimates of the ERP derived from the European Central Bank's dividend growth model (DGM) to estimate a forward-looking ERP which was combined with their estimate of the RfR to produce a sense-check of TMR estimates.<sup>7</sup>
- The aiming up adjustment of 50bps is unjustified on three grounds:
  - Need. Aiming up to attract investment for a government-owned company such as Dublin Airport makes less intuitive sense than where such adjustments have been applied in the past by GB regulators to privately-owned companies. For example, Britain's CMA debated over the course of 42 pages the cases for and against aiming up from its cost of equity estimate for privately owned water companies.<sup>8</sup> We have also seen the CAR re-open the settlement for downside risk; this implies asymmetry in a different direction than implied by Swiss Economics.
  - Methodology. As noted above, the methodology adopted by Swiss Economics already builds in over-estimates of Dublin Airport's WACC. Adding a specific aiming up adjustment on top of these methodological choices amounts to a double-count that increases the cost to passengers and airlines.
  - Scale. Because Dublin Airport's embedded debt costs are used and there is a clear benchmark index for new debt, there is little uncertainty about the estimation of the cost of debt. As a result, the 50bps uplift on the WACC effectively increases returns to equity holders by 100bps (at 50% notional gearing). This scale of uplift is out of step with regulatory precedents and is unmerited on the basis of any expected estimation error. The scale of the adjustment compares unfavourably to, for

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<sup>7</sup> CEPA, PR5 cost of capital estimation – report for Commission for Regulation of Utilities (CRU), 14 July 2020. See chapter 4.

<sup>8</sup> CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report, 17 March 2021. See paragraphs 9.1236 – 9.1404.

example, CRU in PR5 set the WACC at the 67<sup>th</sup> percentile of its range, representing at 25bps uplift over the midpoint of the range.<sup>9</sup>

## 2. The asset beta used in the Draft Decision overstates Dublin Airport's risk

Aer Lingus broadly supports the methodology Swiss Economics used in estimating the asset beta for Dublin Airport. In particular, we support the approach taken to explicitly recognise the measures taken to reduce Dublin Airport's exposure to the Covid-19 pandemic and the decision to exclude the peak of the pandemic from the calculation of asset betas.

We also support Swiss Economics' use of a broad sample of comparator airport operators, and to account for the relative risk of comparators in estimating the beta. Following an extreme outlier event like the Covid-19 pandemic and its impact on the aviation industry, it is natural to perceive the current situation as more risky than the past, but beta is a forward-looking measure and market evidence suggests that systematic risk has not increased. Airport valuations have returned to, or now exceed, pre-pandemic levels (using the preceding year), indicating a high demand amongst investors for airport assets. In fact, the support from government and the flexibility in the regulatory framework to increase charges during the pandemic have shown Dublin Airport to be less risky than previously assumed.

Dublin Airport's lower systematic risk – which includes the flexibility provided by the interim review, limited exposure to Capex and Opex risk, and the protections offered by the single till approach – needs to be more clearly reflected in the weighting approach to comparators. But relying on a weighting approach alone may be insufficient to reflect structural differences, so there should be a downward adjustment explicitly in the beta estimate (e.g. selecting a point estimate that is below the midpoint).

The beta estimate has a significant impact on the overall WACC – for example, retaining the 0.5 asset beta from the 2019 Determination would reduce the WACC estimate by 47 basis points compared to the Draft Decision.

## 3. The elevated inflation environment warrants particular attention

The approach to regulating Dublin Airport's charges seeks to achieve the concept of financial capital maintenance through (i) the return of capital (i.e. depreciation), (ii) the return on capital (i.e. the WACC), and (iii) indexation of the RAB.

We are concerned that – in the current high inflation environment - uplifts from inflation indexation are materially higher than the inflation assumptions used to deflate nominal estimates of returns. This creates windfall gains for Dublin Airport.

British energy regulator Ofgem is currently consulting on whether it should adjust its approach to allowed returns, having noted that:

“The use by the notional company of fixed-rate debt financing - which does not benefit from outturn inflation - creates a leveraging effect to equity investor returns of unexpected inflation levels. By this, we mean that for every 1% increase or

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<sup>9</sup> CRU, Distribution System Operator (DSO) Revenue for 2021-2025, Final Determination Paper, CRU/20/153, 18 December 2020. See chapter 10.

decrease in inflation compared to expected inflation embedded in the WACC, nominal equity returns to the notional company will increase or decrease by more than 1% (all else equal).”<sup>10</sup>

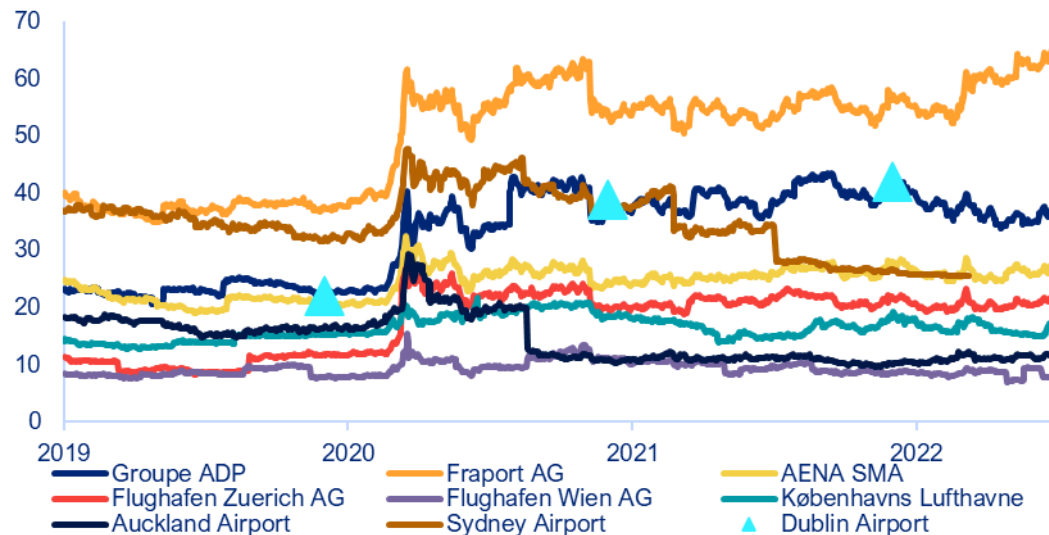
We consider that CAR should similarly explore what options should be adopted for setting the 2023-2026 charges for Dublin Airport to protect passengers from paying for excess returns as a result of the indexation of the RAB.

The CAR and Swiss Economics have used inflation expectations of 1.87% for deflating nominal yields. Using current market-based estimates of inflation expectations over the next five years (i.e., German 5yr breakeven inflation) would increase that inflation estimate to 3.20%. Such an approach would be consistent with the approach used by the CAA for the H7 Final Proposals for Heathrow Airport. There would be a consequent reduction in the cost of debt by c.150bps through the use of updated inflation assumptions.

The notional gearing assumptions assume marginal investment is almost debt financed, creating subsequent issues around financeability.

Swiss Economics proposes the continuation of a 50% notional gearing assumption. The notional gearing assumption has a slight impact on the cost of capital, but also on financeability. We note that a 50% notional gearing assumption is significantly higher than the majority of listed airports (see Figure 1.1).

Figure 1.1: Notional gearing for Dublin Airport and other airports



Source: Bloomberg, Dublin Airport

We address financeability analysis separately below, but the assumed increase in gearing across the portfolio for Dublin Airport is particularly problematic where marginal investment is assumed to be almost entirely funded by debt. This increases the likelihood of perceived financeability problems, when this should not be the case.

<sup>10</sup> Ofgem, RIIO-ED2 Draft Determinations – Finance Annex, paragraph 4.6



## 5. Financeability

The CAR should have due regard to the level of investment to meet the needs of those on whom airport charges may be levied and setting a reasonable rate of return on that capital investment. The financeability assessment is therefore a final cross-check that the building blocks from the regulatory determination process enable access to financial markets and raise finance at a reasonable cost.

In our view, the CAR, based on advice from its financial adviser (Centrus) adopts an unnecessarily overly conservative approach to financeability that goes beyond its regulatory requirements and leads to airport charges that are unnecessarily high for the Third Interim Review period. There are three drivers of our position:

1. Assumptions around financial structure of the new investment programme ('gearing').
2. Adjustments to other relevant building blocks ('building blocks').
3. Principles around relevant thresholds and targets for the regulatory determination ('principles').

The implications from this would be that cashflows brought forward through accelerated depreciation and Capex triggers (in particular, 'A' triggers) are not necessary and their removal would lead to more appropriate airport charges.

### Gearing

The CAR has published the financial model used to assess ratios. This makes it clear that all growth in the RAB over the Third Interim Review period is assumed to be almost exclusively funded by debt.

Between 2022-26, marginal investment is funded 98% by debt, with an increase of €741m in Average Net Debt over the period compared to an average RAB of €759m (all figures in real terms).

The two financial ratios considered by Standard and Poor's in their ratings methodology for the financial risk profile include Net Debt. Higher Net Debt worsens the ratios and creates a greater financeability challenge.

If we halve the increases in Net Debt, assuming the differential amount is instead funded by equity, the FFO/ Net Debt ratio improves by 3.35% over 2023-26 and the Net Debt / EBITDA ratio improves by 0.9x. This leads to very comfortable financial ratios for a mid-investment grade credit rating.

As separately discussed in our response on the cost of capital, we consider that the increase in Net Debt should not be adopted. As shown in that separate analysis, Dublin Airport currently has relatively high levels of gearing compared to listed airports and the amount of Net Debt is more than doubling over 2023-26; this is not appropriate. Financing of a large capital programme should be done with a mix of retained earnings, debt and equity. The company's shareholder may not be prepared to make an equity injection, but there is no reason why customers should face higher charges because the owner is not willing to finance the airport with appropriate equity.



## Building blocks

Assumptions around other building blocks are also currently calibrated generously for Dublin Airport. This will in practice lead to more favourable outcomes on financeability than modelled by the CAR and Centrus. This includes Opex, commercial revenues and passenger forecasts.

- A 6% decrease in Opex improves the FFO/ Net Debt ratio by 1.61% and Net Debt / EBITDA by 0.50x.
- A 7% increase in commercial revenues improves FFO / Net Debt by 1.70% and Net Debt / EBITDA by 0.53x.
- A 7% increase in passenger volumes improves FFO / Net Debt by 1.62% and Net Debt / EBITDA by 0.51x.

Improving the underlying building blocks should be a focus of the CAR in proceeding towards Final Proposals, rather than bringing forward revenues to address a problem that is likely to not be there (if we separate out the use of a lower net debt assumption).

## Principles

We agree with Centrus that the regulatory settlement, as currently proposed, should lead to a credit rating for the notional entity that is at least BBB+. The regulator must consider the trade-off between obtaining a higher investment grade credit rating through higher charges. The approach may lead to a slightly lower cost of debt, but also increases the likelihood of future financeability challenges.

We consider it plausible that Dublin Airport would be able to maintain a solid investment grade credit rating (e.g., BBB+) without the need for accelerated depreciation or Capex triggers included in price cap calculations. This is before correcting for the two factors discussed above (i.e., gearing and building blocks).

Notwithstanding our view on financeability as outlined, we reiterate our support for the incentive mechanism proposed by CAR which is based on a prefunding incentive model for the accelerated delivery of key critical infrastructure.

## 6. Service Quality

Aer Lingus previously supported the service quality regime proposed for 2020-2024 as representing a significant improvement on the regime in place in the previous regulatory period.

The Service Quality Metrics (SQMs) are based on a service level arrangement that results in downward adjustments to the price cap when service levels are not met by Dublin Airport. Airport users are paying for a service standard and, should the Airport be able to deliver over and above this level, this would reflect operational inefficiency on the part of the Airport.

Essentially the Draft Decision amounts to the introduction of a double charge on Airport users: 1) for the inefficient operating costs required to over deliver and 2) for a reward payment to the Airport for this over delivery.

Aer Lingus believes that the CAR should amend its Draft Decision such that the Airport should not be rewarded where service levels over and above the stated standards are delivered.

In line with the Airport's stated ambition and the National Aviation Policy to develop Dublin Airport as a hub, consideration should be given by the CAR to the inclusion of hub related metrics in the SQMs e.g. percentage of departures on stand, Minimum Connecting Time etc. to incentivise the timely delivery of appropriate hub infrastructure and avoid degradation of the transfer product at Dublin Airport.

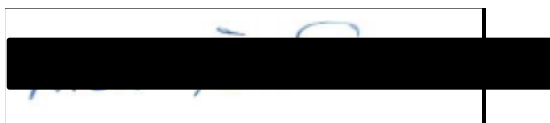
#### **Air Navigation and Transport Bill, 2020 (ANTB)**

Aer Lingus notes the risk highlighted by the CAR that the ANTB may not be enacted before the CAR's Final Decision later this year. We are broadly supportive of Option 1 as set out in section 5.4 of the Draft Decision, which would conclude review this year for 2023 and 2024 whilst also publishing the intended decision in relation to 2025 and 2026 which would then take effect following a further interim review. Such an approach would give the required certainty to the Airport to proceed without delay to deliver the required infrastructure and would also give airlines certainty as to pricing over this period to facilitate their forward planning.

#### **Conclusion**

Aer Lingus is available to discuss any of the issues raised as required by the CAR in advance of the publication of the Final Decision.

Regards,



Niall Timlin  
Director of Corporate Affairs