26 April, 2002.

Ms. Anne Moloney
Deputy Head of Economic Affairs,
Commission for Aviation Regulation,
36 Upper Mount Street,
Dublin 2.

Re: **Consultation Paper on the Implementation of the Levy Pursuant to Section 23 of the Aviation Regulation Act 2001**

Dear Ms. Moloney,

I refer to the above paper and enclose Aer Rianta's submission. Aer Rianta is available to discuss this submission in detail with the Commission and welcomes the views of other interested parties.

Interested parties have been invited to supply the Commission with an email address in order to facilitate automatic notification of changes to postings on the Commission's website regarding this consultation process. Automatic notifications should be directed to Miriam Ryan, Manager Regulation at the following email address: miriam.ryan@aer-rianta.ie

Yours faithfully

Brian Hampson,
Director – Corporate Affairs
and Company Secretary

AR/CAR/04-02

Aer Rianta Response To Commission Paper CP4/2002: Consultation Paper on the Implementation of the Levy pursuant to Section 23 of the Aviation Regulation Act, 2001

April 2002

AerRianta

Table of Contents

Introduction

1. On 4th April 2002, the Commission published Commission Paper CP4/2002, *Consultation Paper on the Implementation of the Levy pursuant to Section 23 of the Aviation Regulation Act, 2001.* This Paper invited interested parties to make submissions to the Commission in relation to its proposals regarding the imposition of a levy on the aviation sector to cover the costs and expenses associated with its office.
2. Aer Rianta makes this submission to the Commission on foot of that invitation, and looks forward to engaging fully in the Commission's consultative process as set out in the timetable on page 6 of CP4/2002. Aer Rianta is available to discuss this submission in detail with the Commission and welcomes the views of other interested parties in relation to it.
3. However, it is important to emphasise at the outset that Aer Rianta has fundamental concerns in relation to the proposals contained in the Commission's Consultation Paper. These concerns (which are elaborated upon below, and in the attached report from NERA Consultants) can be summarised as follows :

    - The allocation of the Commission's costs and expenses in proportion to the time properly expended by it on various cost centres and costs directly related to that function could be applied provided that full transparency on costs is provided by the Commission.
    - The cost associated with economic regulation is a legitimate externally imposed expense over which the airport authority has no discretion. It is clear that it should constitute part of the overall airport cost base that is ultimately passed through in full to users.
    - The view of the Commission that an element of the cost burden associated with airport regulation should be borne by the airport authority and not passed on to users, is one which is not accepted by Aer Rianta and represents a proposal which, in the view of Aer Rianta, is not authorised by Section 23 of the Act, deviates from standard international regulatory practice, is inconsistent with the position adopted by the Commission in its Determination on Airport Charges, and is based upon a false economic premise. To impose the levy on Aer Rianta as set out in the Commission's consultation paper without an appropriate cost pass through mechanism would effectively double count for the impact of regulation on Aer Rianta's cost of capital.
    - The belief as articulated by the Commission that the costs of the levy be borne by non-aeronautical aspects of the business of undertakings is conceptually flawed, improper and outside the scope of the Commission's powers under the Act. This will distort competition in the markets in which those businesses operate.
    - The Determination of airport charges and air terminal services charges has been completed for a five-year period. The process will not require to be revisited for five years (unless an interim review is granted) and it is difficult to see what effort requires to be expended by the Commission on these two functions in between Determinations. This would suggest that the bulk of recurring costs should be allocated to the other

four functions of the Commission, namely slot allocation, ground handling, travel trade licensing and air carrier licensing. A nominal annual overhead fee should be all that is levied against the airport charges and aviation terminal services charges cost centres in the years between regulatory reviews.

- In the absence of transparency the approach that should be adopted in charging the costs of regulation to the industry should be by means of a specific charge per passenger which would be separately identified on the airline ticket. This would make the cost of regulation transparent and would reflect the fact that regulation is supposed to directly benefit the consumer. The costs of regulation in the absence of total transparency should not be bundled in with the Determination of airport charges and aviation terminal services charges. It should be noted that there is a precedent for this approach to specific costs in that airport charges, taxes, insurance etc are separately itemised charges on air tickets.

- Aer Rianta believes that the Commission has failed to explain the basis upon which it claims to be entitled to promulgate the suggested Regulation in respect of expenses that have already been incurred. There is, in particular, no indication in the paper of the "*estimated operating costs of the Commission"* in respect of the period between February 27 2001 and the present time, no indication of whether an estimate was ever prepared in respect of those costs, and no information furnished as to whether the *estimated* costs which Section 23 of the Act envisages the Commission as producing as a precondition to the invocation of the charging power, exceeded or were less than, the actual costs, information in relation to which is provided. Thus, parties responding to the Consultation Paper have no information at all as to the basis envisaged by Section 23, for the charges in respect of the period up to the date of the Regulation. This information, Aer Rianta believes, must be provided in advance of any step being taken to introduce a Regulation of the nature suggested.

- The allocation of costs in CP4/2002 among the various functions of the Commission is also disproportionate. The regulation of airport charges has been unfairly burdened with the bulk of the Commission's costs, despite the significant scope of the other five functions for which it has responsibility and the number of parties involved.

- The Commission's proposal that it will include in its price formula a term which would "correct differences" between the Commissions actual and estimated costs each year appears inconsistent with the express provisions of Section 23 of the Act, and is in any event not accompanied by any indication as to how and when the formula will be calculated.

- The Consultation Paper does not properly or adequately explain or justify critical components of its underlying proposals. Specifically, the basis for the manner in which it is proposed to allocate direct and indirect costs to the various cost centres, the value added to the aviation industry which it is suggested is provided by the Commission, the Commission's own cost base and the most fundamental issues arising from the manner in which the Commission has determined to engage in the process of allocation, are not properly specified, quantified or elaborated upon. Aer Rianta believes that the Commission has not complied with its obligation of

transparency in connection with the proposals, and has created a situation in which it is extremely difficult to respond meaningfully to aspects thereof.

- Aer Rianta has fundamental concerns as to the fairness in principle and propriety of the Commission recovering, and the manner in which it is proposed that it shall recover, costs associated with litigation.
- Together with the issues arising from the lack of transparency of the Commission's cost base, Aer Rianta is concerned that the Commission is proposing to impose upon the industry a very considerable financial burden, in circumstances where there is little or no accountability by the Commission to the industry in respect of those costs, and where there is no demonstration that the cost base is efficient.
- The manner in which the Commission proposes to allocate the cost of slot allocation and co-ordination and groundhandling is unsatisfactory, fails to take account of all classes of person who benefit from these functions and imposes upon Aer Rianta an unfair and disproportionate burden.
- Aer Rianta is concerned as to the absence of any audit of the Commission's own time records (a matter of very great importance having regard to the process of allocation proposed by it).
- The manner in which the Commission has determined to impose the cost of its operations is one that will operate to distort, rather than enhance, competition.

4. Aer Rianta, of course, fully reserves its rights in connection with any Regulation of the nature now suggested and the views expressed by the Commission in its Consultation Paper as to the recoverability of particular category of cost.

Section 23 of the Aviation Regulation Act 2001

5. Aer Rianta is concerned that the Commission has not established the basis for promulgating Regulations pursuant to section 23 of the Air Navigation Act 2001, in respect of some aspects of the proposed levy. Thus, the provision states:

> *For the purpose of meeting expenses properly incurred by the Commission in discharge of its functions under this Act, the Commission shall make regulations imposing a levy to meet, but not to exceed the* ***estimated*** *operating costs and expenses of the Commission…*
>
> [Emphasis Added]

6. The provision plainly operates on the basis that the levy is calculated by reference to the Commission's *estimated* costs, and this is clear from the next part of the sub-section, which states:

> *… to be paid each year beginning with such year as specified in the regulations on such classes of undertakings as may be specified by the Commission in the regulations.*

7. Section 23(4) then provides:

> *An increase in levy may only take effect in the year after the year in which the increase is made in regulations*.

8. However, in two particular respects, the Consultation Paper does not address this aspect of the section. First, the Commission has operated on the basis of *actual* costs incurred in a period (February 27 2001- December 31 2001), without specifying what estimate (if any) the Commission made for that period and, of course, whether that estimate exceeded or was less than, the actual cost incurred. Aer Rianta believes that affected parties should be provided with this estimate, as it appears to provide the basis for the charge envisaged by the provision.

9. The second related effect of this provision arises in the context of the Commission's evident determination to adjust the estimated expenditure to reflect actual expenditure. This is not provided for in the Section, and indeed the manner in which this is to be done is not evident from the Consultation Paper. Aer Rianta believes that affected parties should be advised of the basis for, and manner in which it is proposed to achieve, this proposal.

Transparency

10. Throughout this document, very considerable emphasis is placed upon the absence from the consultation paper of information on the basis of which proper responses can be formulated in relation to, and judgments made, regarding important aspects of the Commission's proposals. These submissions are made without prejudice to Aer Rianta's contention that this fundamental deficiency prevents it from adequately responding to or addressing the issues in the Consultation Paper.

11. As the Commission is aware, it is subject to an over-riding obligation in the discharge of *all* its functions, of transparency, objective justification and proportionality (Section 5 of the Aviation Regulation Act, 2001). This not merely mandates the provision to persons affected by its determinations of an opportunity to make representations in connection with the exercise by the Commission of those functions, but also embraces an obligation to ensure that those representations can be advanced in an informed manner. This is particularly important in a context where the Commission proposes both to estimate its own operating costs, and at the same time reflect that measurement in a levy of the nature proposed here, without any mechanism for independent scrutiny of the reasonableness thereof.

12. Particular issues which present themselves in this regard are considered in detail as they arise throughout. However, Aer Rianta believes it important to emphasise at the outset the many different respects in which the Consultation Paper fails to afford the most basic of information required to properly appraise the Commission's proposals. These include the following :

    - The industry is to be subject to a levy calculated by reference to the Commission's own operating costs, in circumstances in which the industry is afforded no comfort in respect of the value for money achieved by the Commission, and in which the Commission is not apparently independently accountable to the industry in respect of its costs.

    - Those costs, in turn, are posited by the Commission under various headings, which provide no opportunity for analysing the reasonableness of, or necessity for, those costs, nor of the work programmes or circumstances which have given rise to them, and in which no quantification of the outputs associated with them has been provided.

    - The Commission proposes to allocate those costs according to particular activities without there being any evident mechanism for review of the Commission's record keeping and internal time allocation.

    - The Commission then proceeds to propose that direct costs be attributed to the cost centres to which they relate; however, no details have been provided of the level of these costs for any of the particular sectors regulated by it.

13. These disparate examples, which are elaborated upon below, are significant. They not merely operate so as to impede the ability of Aer Rianta to respond fully to parts of the Consultation Paper, they also reflect a fundamental underlying problem with the Commission's overall proposal; the industry is being compelled to fund a regulatory

structure over whose costs the industry has no control, which costs are not amenable to proper ascertainment, analysis or appraisal by the industry, and in respect of which there are not adequate safeguards. This not merely encourages inefficiency on the part of the Regulator, but also undermines the statutory mandates to which reference has been made above.

Costs Properly Incurred By the Commission

14. Section 7 of the Aviation Regulation Act 2001 provides that the principal function of the Commission shall be to regulate airport charges[1] and aviation terminal services charges. The Commission is therefore responsible for regulating a very specific element of Aer Rianta's business i.e. the determination of maximum airport charges. It is not an overall regulator for aviation or for airports. Aer Rianta's operations, particularly the management and operation of the three airports, are regulated by other statutory bodies.

15. It is stated in Section 23 (1) of the Aviation Regulation Act 2001 that:

> *For the purpose of meeting expenses properly incurred by the Commission in discharge of its functions under this Act, the Commission shall make regulations imposing a levy to meet, but not to exceed the estimated operating costs and expenses of the Commission…*

16. It follows therefore that the estimated operating costs and expenses of the Commission that may be recouped through the levy should include only those expenses properly incurred by the Commission in the discharge of its functions under the Act. Costs relating to activities that are extraneous to the Commission's functions should not be included when computing the value of the levy and should not be borne by the industry. Further, the Commission is obliged under Section 5 of the Act to be objective, non-discriminatory, proportionate and transparent. To impose costs relating to extraneous activities violates that principle.

17. The allocation of costs in CP4/2002 among the various functions of the Commission is also disproportionate. The regulation of airport charges has been unfairly burdened with the bulk of the Commission's costs, despite the significant scope of the other five functions for which it has responsibility and the number of parties involved.

18. A further key issue, is the treatment of litigation costs. The Commission notes on page 11 of CP4/2002 that

> *"In certain cases the deciding body may award costs to the Commission, and, in other cases costs may have to be paid by the Commission. There will in any event be a portion of costs which will require to be borne by the Commission".*

It is clear that ultimately the Commission expects its litigation costs to be borne by the industry through the levy. This seems fundamentally unfair, in circumstances where it appears to be envisaged that even in circumstances where the Commission

[1] Specifically, the Air Navigation and Transport (Amendment) Act, 1998 defines "airport charges" as

a. *charges levied in respect of the landing, parking, or taking off of aircraft at an aerodrome including charges for air-bridge usage but excluding charges in respect of air navigation and aeronautical communications services levied under section 43 of the Act of 1993,*
b. *charges levied in respect of the arrival at or departure from an airport by air of passengers, or*
c. *charges levied in respect of the transportation by air of cargo, to or from an airport, as may be appropriate;*

The Commission's other functions are also set out in the 2001 Act.

unsuccessfully commences or defends litigation against undertakings in the industry, that part of the costs of that exercise should be borne indirectly by the parties who have succeeded in their claims.

19. There thus is an evident anomaly in a situation where, if an undertaking takes an action against the Commission, is successful and obtains an order for its costs from the Court, the Commission's liability for those costs is to be treated as part of its overall expenses for the purpose of the levy, with the consequence that the undertaking, although successful, would ultimately have to bear part of its own costs, as well as the costs of the Commission, thereby suffering significant financial prejudice. That anomaly underlines the considerations already referred to above in respect of the Commission's accountability.

20. Where the Commission is found to have acted *ultra vires* in discharging its functions, then the costs incurred by the Commission in such proceedings should not be considered to be expenses "properly incurred" for the purpose of Section 23(1) and therefore should not be recoverable through the levy. Otherwise the industry would unfairly have to bear the burden of costs incurred where the Commission did not discharge its functions properly.

21. Without prejudice to the preceeding points, if it be the case that the Commission's litigation costs are to be recouped through the levy, regardless of the outcome of the litigation, then the litigation costs incurred by regulated undertakings that challenge the Commission should also be allowed. Such costs should be spread equally across all classes of undertakings connected with the function to which the proceedings relate. Any other model undermines fundamentally the entitlement of parties involved in the industry to litigate the validity of actions of the Commission, presents an improper barrier to the exercise by such parties to their right of access to Court and interferes with the power of the Court to grant orders for costs. It would, in essence, constitute a tax on litigating against the Commission. This would have to be clearly provided for in the Act, were it to be permitted in the manner envisaged by the Commission's proposals.

22. In fact, the making of provision having this effect *undermines* the principles of transparency provided for in the Act, operating as it does to remove an incentive to litigate, therebv diminishing the accountability of the Commission in the manner envisaged by the Act, and thus reducing its efficiency. This cannot be consistent with the concept of costs *properly incurred* as provided for in the Act.

Conclusion

- **The estimated operating costs and expenses of the Commission that may be recouped through the levy should include only expenses properly incurred by the Commission in the discharge of its functions as set out in the Aviation Regulation Act 2001.**
- **CP4/2002 is lacking in transparency. It is difficult for the industry to provide informed comment on the Commission's proposals in the absence of full information on the costs associated with each of the Commission's activities.**
- **Where the Commission is found to have acted ultra vires in discharging its functions, then the costs incurred by the Commission in such proceedings should not be considered to be expenses properly incurred for the purpose of Section 23(1) and therefore should not be recoverable through the levy.**

The Level and Nature of Costs Appropriate to the Commission's Functions

23. The levy proposed by the Commission for the determination of maximum airport charges at Dublin, Shannon and Cork airports works out at €0.12[2] per passenger for 2002. This is a very significant cost and is disproportionate relative to the charges imposed by it for regulating airport terminal services charges and to the charges imposed on airports in the UK by the CAA's Economic Regulation Group.

    - The Commission has adopted the same regulatory regime for aviation terminal services charges as it has for the regulation of airport charges. Despite this it has applied a charge for regulatory fees of €3.8m for the 19 month period from February 2001 to September 2002 in its Determination on the maximum levels of airport charges (CP2/2002) but has applied regulatory fees of only €250,000 for the twenty four month period from February 01 to March 03 in its Determination in respect of airport terminal services charges (CP3/2002).
    - The CAA's Economic Regulation Group (ERG) is responsible for directly regulating airport charges at four airports in the UK[3] with a total passenger throughput of more than 100 million per annum, overseeing the charges imposed by all other airports in the UK, regulating air traffic services and airlines and provides advice on aviation policy from an economic standpoint to both the Government and industry. The ERG also collects, analyses and publishes statistical information on airlines and airports.[4] The CAA's 2001 Accounts show a turnover of more than €6m for this function – the Commission is charging two thirds of this figure for regulating the three Irish airports alone.

24. Section 23 (7) of the Aviation Regulation Act 2001 states that

    > *The Commission shall ensure that its own costs of operations are kept to a minimum and are not excessive.*

    The Commission, in making its Regulations should state that the costs associated with the levy are minimum and not excessive and should give details of the procedures it has adopted to ensure this is the case.

25. Such an approach is recommended by the recent policy document, *Governance and Accountability in the Regulatory Process*[5], which notes that:

    > *"the interests of democracy demand that such delegation of authority* (from Minister to regulator) *be accompanied by clear and defined accountability mechanisms. Accountability…concerns the obligation to explain, answer for and bear the consequences of the manner in which one has discharged duties, fulfilled functions and utilized resources"*

[2] Derived by taking 75% of 2002 net expenses and dividing by the centreline forecast number of passengers for the three airports in 2002 (i.e. 20,535,000).
[3] Heathrow, Gatwick, Stansted and Manchester
[4] Civil Aviation Authority Annual Report and Accounts, 2001
[5] Governance and Accountability in the Regulatory Process: Policy Proposals, Department of Public Enterprise, March 2000, p8

26. The Commission should be required to demonstrate the efficiency of its operations to those that are required to pay for the costs of its office. It should be noted that the UK airports regulator, the CAA ,commits to

> *"keep under review its individual charging schemes, to ensure that charges are, wherever possible, cost-related, fair and equitable."*[6]

A similar commitment is given by OFGEM

> *"I am committed to ensuring that Ofgem controls its costs carefully, and manages its resources efficiently"*[7].

27. It is impossible to ascertain from the estimates of net expenses totalling €5,528,000 provided by the Commission in the Appendices II and III to CP4/2002, whether or not the significant level of cost represents value for money or is in line with market rates. This lack of transparency on the part of the Commission must be addressed by reference to the following points:

- The Commission should confirm that it complies with public procurement rules.
- The Commission must commit to following an open and transparent tender procedure for all cost items.
- The Commission has not set out the accounting policies underpinning its costs. The Commission's approach to and treatment in the accounts of issues such as, asset valuation, depreciation, amortisation, leases, loans, borrowing costs etc. should be disclosed.
- The Commission should confirm that it meets the requirements of the Department of Finance Code of Practice for the Governance of State Bodies, particularly as this relates to procurement functions, disposal of assets and remuneration.

28. The level of costs in 2002 are excessive at €1.95m before judicial review costs. The Determination of airport charges and air terminal services charges has been completed for a five-year period. The process will not require to be revisited for five years (unless an interim review is granted) and it is difficult to see what effort requires to be expended by the Commission on these two functions in between Determinations. This would suggest that the bulk of recurring costs should be allocated to the other four functions of the Commission, namely slot allocation, ground handling, travel trade licensing and air carrier licensing. A nominal annual overhead fee should be all that is levied against the airport charges and aviation terminal services charges cost centres in the years between regulatory reviews.

29. CP4/2002 is not transparent in relation to the following cost headings:

- Staff costs - The Commission has not indicated the staffing levels associated with its estimates for staff costs of €865,000 in Appendix II and €1,007,000 in Appendix III. Aer Rianta notes that if the staff costs figure for the ten months of 2001 is extrapolated for 12 months, the result is higher than the budget figure for 2002. This inconsistency is unexplained by the Commission.

[6] CAA Annual Report and Accounts 2001

[7] Chief Executive's Statement, Ofgem Proposed Plan and Budget 2001/2

- Accommodation - The accommodation cost heading increases by almost 200% from €56,000 in Appendix II to €165,000 in Appendix III. There is no analysis to explain this enormous increase. A *"need for new premises"* is mentioned on page 16 of CP4/2002, however no explanation is provided as to why this need exists or to justify why the existing accommodation *"does not have the necessary space or facilities required by a statutory body to discharge its functions appropriately".* It should be noted in this context, that the Commission does not require a centre city location for the purpose of fulfilling its functions and this should be a key consideration in achieving the minimum cost objectives required by statute. The Commission is proposing that "*the proportion of Commission staff working in the Travel Trade licensing be used to allocate a portion of accommodation costs to the Travel Trade Licensing Cost centre"(pg.10 CP4/2002).* However the Commission has not provided any details in relation to this proposal.
- Professional advisers – A figure of €1.266m is allocated to this cost heading for the ten months to 31/12/01 (i.e. 48% of total costs for this period). According to a report in the Official Journal of the European Communities, the Commission's contract with consultants IMG amounted to €1.125m. This cost appears excessive, particularly in the context of the fact that the Commission already directly employs a number of economists, and other experts and has 16 staff in total employed directly to carry out its functions.
- Travel and Subsistence – A figure of €101,000 is allocated to this cost heading for 2001. We believe that the Commission has 16 staff members, two of whom are administration staff, which one would expect to have little requirement for travel. If these are excluded, the costs for travel and subsistence amount to over €7,200 per Commission employee for a ten month period. This figure is excessive, given that all of the Commission's functions are in Dublin where it is located.
- Communications and Media Relations - A sum of €209,000 is attached to this cost heading for the 10 months of 2001 and a sum of €144,000 is proposed in the draft budget for 2002, Aer Rianta must assume that the bulk of this cost is absorbed by the design, set-up and maintenance of the Commission's website. The Commission has carried out minimal advertising and the design of the Commission's Stationery logo cannot be responsible for a significant proportion of the 2001 spend. It is Aer Rianta's view that the costs associated with the design, set-up and maintenance of the Commission's website are disproportionate when compared with average industry rates. Taking aside the issue of one-time set-up and design costs of the website the cost of €144,000 which has been allocated for 2002 is excessive and inefficient. It would be expected that a website with such a limited level of interactivity would be very cost efficient to maintain. This has not been demonstrated in the draft budget for the Income & Expenditure of the Commission for 2002.

30. Section 26 of the Act requires the Commission, within the first three months of the year, to make a report to the Minister in relation to the performance of its functions in the previous year and its proposed work programme for the following year. The Commission has not discussed its proposed work programme with the aviation industry. This is in contrast to

the transparent approach adopted by the UK airports regulator, the CAA[8], which consults widely with the industry prior to formalising its work programme for the year. Other UK regulators, for example, OFGEM and OFFREG also publish full details of key deliverables in their work programmes for each regulatory year and the direct costs associated with each element. This is an approach that should be adopted by the Commission for Aviation Regulation, particularly given the fact that its work programme will drive the costs of the regulatory office, which the industry will ultimately have to pay in the form of the levy.

31. The Commission has stated that

> *"The estimated operating costs and expenses…will change from year to year depending on the level of activity of the Commission and the related costs and expenses in a given year. This will be reflected in varying amounts being imposed on Undertakings from one year to the next."*[9]

According to its 2001 Annual Report, the CAA's Corporate Plan 2001/2002 to 2005/2006 "*assumes average price increases* (in CAA charges to industry*) will be limited to less than movements in the Retail Price Index".* Such a statement provides some certainty to the UK airports industry going forward and the Commission should also make such a commitment.

32. The CAA also provides an indication of the annual percentage change in the costs to the aviation industry for regulatory services and explains any differentials in the components. Such a transparent approach contrasts sharply with the lack of clarity which surrounds the data presented by the Commission in the Appendices to CP4/2002. The CAA methodology should be considered by the Commission for the future.

Conclusion

- **A key principle for the effective and efficient operation of regulatory systems is that the costs associated with regulation do not outweigh the benefits to overall economic welfare. The Commission for Aviation Regulation proposes to place a significant cost burden on the aviation industry but has not elucidated the value added which it will provide in return.**
    - **It has not provided supporting evidence to demonstrate that its cost base is efficient**
    - **It has failed to consult on a work programme for the upcoming regulatory year (in the case of airports regulation, six months of this year has already passed)**
    - **It has failed to indicate or quantify the outputs that it seeks to achieve in return for the cost burden associated with its office**
- **The Commission should address the lack of transparency surrounding its cost base and afford the industry the opportunity to comment thereon, prior to laying Regulations in respect of the levy before the House of the Oireachtas as required by Section 23(6) of the Aviation Regulation Act 2001.**

[8] Oftel and Ofgem undertake similar annual consultative processes in relation to their work programmes and budgets prior to formalisation.
[9] CP4/2002, page 4

Allocation of Appropriate Costs to the Commission's Activities and Undertakings Liability to Pay

33. The Commission has suggested a number of ways to allocate the costs incurred in carrying out its functions on page 8, CP4/2002 – each is addressed in turn below:

    - It would not be fair to impose a levy on the aviation industry on the basis of a percentage of turnover of each undertaking, without reference to the degree of interaction between the Commission and the business or sector in question. Though, as noted by the Commission, this approach would be relatively simple to administer, it could result in the imposition of very arbitrary and disproportionate cost burdens on certain sectors of the industry.
    - The imposition of a levy on the basis of either a fee per passenger or a fee per aircraft movement, would cause significant administrative difficulties when it comes to deciding the proportion of the fee used to cover regulation of terminal services versus the regulation of airport charges. It would also be difficult to establish links between this form of allocation and the travel trade licensing and groundhandling cost centers.
    - The allocation of the Commission's costs and expenses in proportion to the time properly expended by it on various cost centres and costs directly related to that function could be applied provided that full transparency on costs is provided by the Commission.
    - In the absence of transparency the approach that should be adopted in charging the costs of regulation to the industry should be by means of a specific charge per passenger which would be separately identified on the airline ticket. This would make the cost of regulation transparent and would reflect the fact that regulation is supposed to directly benefit the consumer. The costs of regulation in the absence of total transparency should not be bundled in with the Determination of airport charges and aviation terminal services charges. It should be noted that there is a precedent for this approach to specific costs in that airport charges, taxes, insurance etc are separately itemised charges on air tickets.

34. The Commission has stated that similar percentages to those presented on page 9 of CP4/2002 which illustrate the time expended by Commission staff on each cost centre

    > *"will be estimated each year for 2002 and thereafter and will be used for the allocation of costs on an annual basis in the future".*

35. According to CP4/2002, 75% of staff members time was expended on airport charges regulation, whilst it is claimed that only 15% was devoted to performing a similar function in relation to the regulation of airport terminal services charges. 10% of staff time is allocated to the Commission's other four important functions. None of these figures are substantiated.

36. It is very difficult to understand how 75% of the Commission's time could have been devoted to airport charges regulation and Aer Rianta completely rejects this disproportionate and unfair allocation.

- According to the Commission's website it has approved more than 30 ground handling companies, licensed 348 travel agents, 80 tour operators and 20 air carriers since February 2001. It is impossible that 75% of staff time could have been allocated to airport charges regulation when during this period, the Commission interacted with so many other parties and carried out its obligations in relation to these other functions.
- In the period February – December 2001, the Commission issued 15 official consultation and decision documents. Of the papers prepared only 9 were related to airport charges regulation. It is clear from this that the Commission devoted a significant timespan to preparing and evaluating submissions in regard to its other functions and that a 75% allocation to airport charges regulation is disproportionate.
- The Determination on airport charges was made on 26th August 2001. Even if the entire Commission staff had worked full time on airport charges regulation for the six month period (which was not the case), this would mean that only 60% of total staff time should be allocated to this cost centre.
- In fact, Aer Rianta had very little interaction with the bulk of the Commission staff during the airport charges regulatory review. Out of 16 staff employed by the Commission, only 6 were directly involved in the Determination of airport charges, interacted formally with the company, attended meetings with the company, addressed queries to the company or toured the airports for the purpose of the regulatory review viz:
    - Bill Prasifka, Commissioner
    - Cathal Guiomard, Head of Economic Affairs
    - Kieran Baker, Head of Administration
    - Anne Moloney, Deputy Head of Economic Affairs
    - Jarleth Burke, Head of Legal Affairs
    - Oliver Hogan, Economist

  All of the above named individuals were also involved in the parallel regulatory process for aviation terminal services charges and the Commissioner, Head of Administration and Head of Legal Affairs were undoubtedly involved with other Commission cost centres while the airport charges review was underway. A 75% allocation of staff time to airport charges regulation is therefore not consistent with the limited number of staff directly involved in airport charges regulation and with the extent to which they were solely involved with the function.

37. The scale of the differential in time allocated between airport charges regulation and airport terminal services charges regulation is all the more difficult to fathom given that the same methodology was adopted by the Commission for regulating both cost centres. This required similar exercises to be undertaken in respect of the estimation of the cost of capital, analysis of operating costs, projections of capital expenditure etc. Furthermore the regulatory function in respect of airport charges was carried out over a six-month period, whilst the work associated with the Determination in respect of Aviation Terminal Services Charges was spread over twice that timespan.

38. The percentage of time spent by Commission staff on the Ground Handling cost centre also appears very low at 3%. A wide range of important and onerous responsibilities relating to ensuring safety and security of ground handling operators at airports fall to the Commission under Regulation 12 (3) of S.I. 505 of 1998 - the Commission must ensure that the applicant:

    (a) is competent as respects experience, financial resources, equipment, organization, staffing, maintenance and operating procedures to ensure the security and safety of installations, of aircraft, of equipment and of persons

    (b) is adequately insured to cover liability in respect of employees, passengers, luggage, cargo, mail and third parties, and,

    (c) in respect of its employees, complies with the requirements of the Acts mentioned in Schedule III.

    It would be expected that such an important and critical function would require a greater level of attention than the allocation of just 3% of the Commission's staff time suggests.

39. The accuracy of the Commission's record keeping is obviously a key concern in a situation where the payment of large sums of money is dependant on the time that it records as being allocated to its various functions. In the interests of transparency and to avoid dispute, it is imperative that the Commission submits its time allocation records for independent audit prior to the annual finalisation of percentages used for the purpose of the calculation of the levy. The Commission should also publish details of the system used to record the proportion of staff time allocated to various functions so that the industry can be sure of its accuracy, reliability and appropriateness.

40. The Commission has stated that direct costs will be attributed directly to the cost centres to which they relate but has given no details of the level of these costs for any of the sectors regulated by it. It is difficult for Aer Rianta to provide informed comment on the Commission's proposals in the absence of transparency regarding the detailed allocation of direct and indirect costs to specific functions.

41. The Commission's approach contrasts with the more transparent and accountable approach adopted by UK regulators, many of which provide estimates of the direct costs associated with their principal activities. For example, OFGEM, the gas and electricity regulator has set out the overall costs associated with its activities in some detail in its *Plan and Budget 2001-02* but it has also specified the direct costs associated with the function of regulating monopoly businesses as follows:

£000 Feb 01-Mar 02	Staff	Contractors	Other	Total
	1,257	1,791	188	3,236

42. The Commission has suggested the appropriate undertakings to which costs should be allocated for each cost centre. Three of the cost centres are relevant to Aer Rianta viz:

    - Regulation of Airport Charges
    - Slot Allocation and Coordination
    - Ground Handling

The cost centers for aviation terminal services charges, travel trade licensing and air carrier licensing have no connection with Aer Rianta's business and the company should not be required to fund any of the costs or expenses associated with work carried out by the Commission in relation to them.

Regulation of Airport Charges

43. The cost associated with economic regulation is a legitimate externally imposed expense over which the airport authority has no discretion. It is clear that it should constitute part of the overall airport cost base that is ultimately passed through to users.

44. Aer Rianta has established that the cost burden associated with airports regulation in Australia and Europe is commonly borne by Government, whilst in the United States, the airports regulatory authority the FAA is primarily funded through direct taxes on passenger airline tickets.

45. Following a request from Aer Rianta, NERA surveyed UK regulatory practice in relation to this issue and found that for regulators in the airports, rail, energy and water sectors, best regulatory practice is to impose the levy on regulated activities only and to treat this cost as a pass through item.

    - The UK Civil Aviation Authority (CAA) recovers the costs of regulation from designated airports and the airport operators recoup these charges through their regulated revenue by including them in their operating costs estimates that they submit to the CAA at the periodic review.
    - The energy regulator, Ofgem, treats licence fees as a cost pass-through. The National Grid Company (NGC) price control includes an explicit adjustment to the level of regulated revenues equivalent to its liabilities in respect of licence fees. As such, NGC is able to set charges to recover the full costs of licence fees. Price controls for other companies that have their prices regulated by Ofgem also have explicit cost pass-through provisions.
    - The Office of the Rail Regulator (ORR) allows Railtrack to recover the costs of licence fees. At periodic reviews, the forecast costs of licence fees are included in a group of costs called "non-controllable operating expenditure". These are then recovered from Train Operating Companies (TOCs) through the fixed component of track access charges.
    - The UK water regulator, Ofwat, also allows for the costs of licence fees to be included within regulated revenues.

46. In both its Original and Revised Determination the Commission rightly adopted a pass through methodology in dealing with the expenses associated with airport charges regulation in the regulatory formula. This approach should be retained for the future.

47. However, in CP4/2002, the Commission has suggested that airport users should not bear all regulatory costs and expenses because the system of independent economic regulation should provide improved certainty to Aer Rianta which in turn reduces the cost of capital requirement. Aer Rianta asked NERA to assess this proposition. It found that the impact of regulation on the cost of capital of regulated firms is by no means certain (see appended Report from NERA).

48. Evidence shows that arbitrary and unanticipated interventions by regulators can increase share price volatility and perhaps beta risk, with a certain degree of persistence following the regulatory event. However, there is also some evidence to suggest that a fair, rigorous and transparent price review process can decrease risk.

49. It is clear from NERA's review that there is no uniform impact of regulation on regulated companies; it appears to vary by regulator, by regulated sector and through time. The empirical evidence does not support the Commission's assertion that Aer Rianta "benefits" from regulation in the form of a lower cost of capital.

50. However, even assuming that the Commission is correct in its assertion, that there is some benefit to the regulated entity's cost of capital from regulation, NERA notes that the Commission's proposed approach to the recovery of the Levy is fundamentally unsound as the effects of regulation on the cost of capital, whether positive or negative, are already fully captured in the cost of capital that the Commission has applied in setting Aer Rianta's price cap.

51. In its estimation of the cost of capital for Aer Rianta[10], NERA explicitly state that the regulatory regime is an important determinant of beta risk and partly on this basis select BAA, which operates in a similar regulatory environment to Aer Rianta, as the appropriate comparator company. The Commission's own consultants[11] acknowledge that their estimate of Aer Rianta's cost of capital, based on BAA, reflects the expected business risk associated with Aer Rianta's operations. They conclude that *"Aer Rianta's operational and business risks are not sufficiently different from BAA's to warrant significant adjustment to BAA's beta"*[12]. Thus, the authors accept that the business risk captured in BAA's beta estimate appropriately reflects Aer Rianta's expected risk. NERA points out that business risks include regulatory factors so, in effect Kearney and Hutson conclude that the impact of the regulatory regime is appropriately captured in their proxy beta estimate for Aer Rianta.

52. There are therefore no "residual" benefits not already taken into account in determining Aer Rianta's allowable costs that could be "offset" against the cost of the Levy. To impose the levy on Aer Rianta as set out in the Commission's consultation paper, without an appropriate cost pass-through mechanism, would effectively double-count for the impact of regulation on Aer Rianta's cost of capital. The Commission's proposal is therefore conceptually flawed, unfair and should be withdrawn.

53. The Commission goes on to give non-aeronautical operations as an example of a source of revenue from which the levy might be financed. It is unclear whether the Commission in using this example, is referring to the non-aeronautical revenues within the single till[13] or to revenues associated with non-aeronautical activities outside the single till.

---

[10] NERA Report on Cost of Capital, Appendix 5, Aer Rianta Submission in Response to CP6/2001, July 2001

[11] Aer Rianta's Cost of Capital, Report by Professor Colm Kearney and Elaine Hutson; Appendix VI, CP8/2002.

[12] Kearney and Hutson, op.cit., p161.

[13] It should be noted that any benefit for users in recouping regulatory costs from non regulated activities within the single till will be balanced by the reduction in the level of unregulated revenues to offset them – in effect it is a zero sum game for airport users.

54. Section 23 of the Act does not authorise the Commission to impose a levy on Aer Rianta's non-regulated activities and, accordingly, to the extent that any Regulations made by the Commission purport to do so, those Regulations will be ultra vires the Commission. Furthermore, for the Commission to adopt such an approach at this stage would be wholly inconsistent with the approach it has adopted to date on this issue. In relation to the Commission's determination of airport charges, a number of parties submitted to the Commission that revenue from Great Southern Hotels and Aer Rianta International should properly be included in the regulatory till. These submissions were rejected by the Commission on the ground that "these activities do not have a sufficient nexus to the regulated activities."[14] That being the case, it would be irrational for the Commission now to take the view that the revenue from such activities should partially fund its operating costs.

55. As pointed out by NERA in the attached paper, there is no theoretical basis for the allocation of any portion of the levy to non-regulated activities nor is there any basis in precedent. The Commission's proposal is contrary to regulatory practice by other regulators in Ireland and elsewhere, and is inconsistent with the promotion of economic efficiency.

56. Non-aeronautical activities are not directly regulated because they operate in competitive markets. To burden these activities with a cost which competitors are not required to bear would be distortionary in terms of prices and output, because it would place them at a competitive disadvantage with non-aviation sector businesses with which they compete in the markets for non-aeronautical services. This would also be contrary to the requirement that the Commission shall have due regard to promoting the efficient and effective use of all resources by the airport authority as set out in Section 33c of the Aviation Regulation Act 2001. It makes no sense, for example, to make investors in a hotel business, still less hotel guests, pay for airport regulation.

57. The Commission's proposal is also flawed on the basis that if the Commission takes some regulatory costs out of the regulatory formula by levying them on Aer Rianta's non-aeronautical activities outside the single till, then the operating cost amount allowed for in the formula would be less and this could result in Aer Rianta recovering more than the maximum average yield for reasons totally unconnected with the company. Users would be negatively impacted in the short-term as they would pay higher prices and ultimately Aer Rianta would be penalised as it would have to repay any over-recovery it made, plus interest, to users.

58. The Commission's proposal raises serious concerns regarding the predictability and consistency of the regulatory regime. The consistent application of airport charges regulation and the consistency of operations between successive regulators is an issue of major importance for the industry, especially where airports are undertaking investment which needs to be recouped over an extended time-frame. It is critical that the "rules of the game" do not suddenly change because of a change in the regulator's behaviour within the legislative framework as this would significantly undermine financial markets and funding institutions confidence in airports. Indeed, as the empirical evidence suggests, beta risk

[14] CP9/2001, at page 139.

has been observed to increase as a result of arbitrary and unpredictable regulatory intervention.

59. The Commission mentions the fact that it has included a term in the price formula to correct differences between the Commission's actual and estimated costs each year but it has not explained how and when the W term will be communicated for the purposes of calculating the price cap. It should be noted in this context that the Commission has set out its costs and expenses on a calendar year basis for 2002 whilst the regulatory year runs from 27th September 2001 to 26th September 2002. In the interests of transparency, the Commission must clarify for the industry the accounting policies and principles which it proposes to adopt in calculating the W term and allow the industry to comment on same.

Slot Allocation and Coordination

60. Coordination is designed to balance the supply and demand for scarce airport capacity. IATA has stated that the prime objective of co-ordination is to

> *"ensure the most efficient use of scarce airport resources in order to maximize the benefits to the greatest number of airport users and the traveling public"*

It is clear from the above that the beneficiaries of slot allocation and co-ordination are the airport operator, the carriers and ultimately the passenger. On this basis, it would clearly be unfair to allocate the levy entirely to the airport operator as the Commission proposes at section 6.3b, page 14, CP4/2002.

61. A 50/50 split between the airport authority and the main airlines at Dublin would be the best means of apportioning the costs of this important regulatory function. The airline element of the charge could perhaps be allocated on a proportional basis, with a minimum threshold.

62. This approach is the most suitable because:

- A precedent for a 50/50 split is set by the current systems operating in Denmark, France, Italy and Sweden.
- A 50/50 split will ensure that neither airport, nor airlines can be judged to have undue influence over the coordination process due to the level of payment made.
- The only EU country of which Aer Rianta is aware where a higher proportion (than 50%) of funding is paid by the airports is the UK, where the airport operators pay 75% of the cost associated with slot coordination. However, there is a far larger base of airports over which the costs may be spread when compared to the Irish situation. Currently, 13 UK airports contribute to the 'airport component' of the total slot coordination charge. In the case of Aer Rianta, the burden of cost will be levied against just one airport – Dublin, which makes a higher level of cost allocation inappropriate.

63. It is not clear from the information provided by the Commission in CP2/2002 regarding the costs of its office which have been factored into the price cap at Dublin Airport, whether an estimate for the costs associated with slot coordination have been included. If, as proposed by the Commission in CP4/2002, these costs are levied in full or in part on the airport operator, the Commission must indicate whether these costs are already included

in the Determination on maximum airport charges. If they are not it must advise on the means whereby this additional cost is to be included in the formula. Aer Rianta proposes that for ease of administration, the element of cost, if any, which falls to be borne by the airport company in respect of this cost centre, be considered as an under-recovery for the purposes of the current price cap.

Ground Handling

64. In Section 6.4 the Commission proposes that an annual administration charge that reflects the costs of this cost centre be levied on approved ground handling operators.

65. As noted in Paragraph 26 above, the percentage of time spent by Commission staff on the Ground Handling cost centre appears very low at 3% given the importance of the function for safety and security of operations by ground handlers at airports.

66. Each company that applies to the Commission for approval to carry out ground handling functions should be levied with a charge that reflects the costs associated with assessing applications. This would be a more equitable approach than that proposed by the Commission as it avoids a situation whereby approved ground handling companies would carry the costs associated with the screening of those companies that might ultimately be denied approval to operate from the Commission.

67. The remaining costs associated with day-to-day administration of the ground handling cost centre should then be apportioned equally across all approved ground handling companies.

68. For the purpose of clarity, it would be preferable if the Commission, rather than specifying Dublin, Cork and Shannon in the Regulations, noted instead that the administration charge will be levied on ground handlers at Irish airports covered by European Communities (Access to the Groundhandling Market at Community Airports) Regulations 1998 (S.I. 505 of 1998).

Conclusion

- **Aer Rianta considers that the allocation of the Commission's costs and expenses to its functions in proportion to the time expended by it on various cost centres is a possible approach.**
- **In the interests of transparency and to avoid dispute, it is imperative that the Commission submits its time allocation records for independent audit prior to the annual finalisation of percentages used for the purpose of the calculation of the levy.**
- **A higher degree of transparency regarding the allocation of direct and indirect costs to the various cost centers is essential if the industry is to be in a position to comment in an informed manner on the Commission's proposals.**
- **A disproportionate, unfair and arbitrary time allocation appears to have been made to the airport charges regulation cost centre, particularly when compared to that allocated to aviation terminal services charges or groundhandling functions. The**

allocation of 75% is neither supported on a staff allocation, time allocation or any other basis.

- **The Commission has suggested the appropriate undertakings to which costs should be allocated for each cost centre. Only three are relevant to Aer Rianta viz:**
  - **<u>Airport Regulation</u>**

    The Commission's proposed approach to the recovery of the Levy is fundamentally unsound as the effects of regulation on the cost of capital, whether positive or negative, are already fully captured in the cost of capital that the Commission has applied in setting Aer Rianta's price cap. The suggestion that any "benefit" could be recouped from non-aeronautical activities would be distortionary and in contravention of the requirements of the Commission under the Aviation Regulation Act 2001. The cost associated with economic regulation is a legitimate externally imposed expense over which the airport authority has no discretion. In line with best regulatory practice, it should constitute part of the overall airport cost base that is ultimately passed through to users.

  - **<u>Slot Allocation and Coordination</u>**

    In line with precedent in Denmark, France, Italy and Sweden, a 50/50 split between the airport authority and the main airlines at Dublin would be the best means of apportioning the costs of this regulatory function. This ensures that neither airport nor airlines can be judged to have undue influence over the coordination process due to the level of payment made.

  - **<u>Ground Handling</u>**

    Each company that applies to the Commission for approval to carry out ground handling functions should be levied with an application charge that reflects the costs associated with assessment of applications. The remaining costs associated with day-to-day administration of the ground handling cost centre should then be apportioned equally across all approved ground handling companies

THE IMPLEMENTATION OF THE LEVY

A Response to the Commission for Aviation Regulation's Consultation Paper, CP4/ 2002

A Report for Aer Rianta

Prepared by NERA

April 2002
London

Project Team:
Ian Jones
Dr Richard Hern
James Grayburn

n/e/r/a

National Economic Research Associates
Economic Consultants

15 Stratford Place
London W1C 1BE
Tel: (+44) 20 7659 8500
Fax: (+44) 20 7659 8501
Web: http://www.nera.com

An MMC Company

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The Commission for Aviation Regulation (the Commission) recent Consultation Paper, CP4/2002, on the implementation of the Levy pursuant to Section 23 of the Aviation Regulation Act, 2001, proposes that because Aer Rianta's cost of capital is reduced by the system of independent economic regulation established under the Act, some part of the Commission's costs, as reflected in the Levy, should be recovered from Aer Rianta's unregulated business, rather than as a cost pass-through. NERA's careful assessment suggests that the impact of regulation on the cost of capital of regulated firms is by no means certain and that the empirical evidence does not support the Commission's assertion that Aer Rianta "benefits" from regulation in the form of a lower cost of capital. However, even assuming that the Commission was correct in its assertion, its proposed approach to the recovery of the Levy is fundamentally unsound, for two reasons.

- First, the effects of regulation on the cost of capital, whether positive or negative, are *fully captured* in the cost of capital that the Commission has applied in setting Aer Rianta's price cap. There are therefore no "residual" benefits not already taken into account in determining Aer Rianta's allowable costs that could be "offset" against the cost of the Levy. In other words, the Commission's methodology "double counts" any benefits of regulation on the cost of capital.

- Second, recovering the costs of the Levy from Aer Rianta's non-regulated businesses is distortionary, because it would place Aer Rianta at a competitive disadvantage with non-aviation sector businesses with whom it competes in the markets for non-aeronautical services.

Not surprisingly, therefore, the Commission's proposed approach is also contrary to good regulatory practice, which as our survey of UK regulators shows, treats equivalent levies on regulated firms as cost pass-through items for the firms' regulated activities.

1. INTRODUCTION

National Economic Research Associates (NERA) is a leading international economic consultancy, specialising in the application of microeconomics to regulation and competition issues, policy evaluation and business strategy. NERA was established in 1961, and now employs some 350 professional economists in London, Brussels, Madrid, Sydney and offices across the United States.

NERA was commissioned by Aer Rianta to respond to the Commission's Consultation Paper on the Implementation of the Levy pursuant to Section 23 of the Aviation Regulation Act, Commission Paper CP4/ 2002. Specifically, NERA was asked to examine the Commission's proposed methodology for the implementation of the levy scheme on Aer Rianta. This paper sets out NERA's analysis and conclusions.

In its consultation paper the Commission states that the system of independent economic regulation established under the Act should provide improved certainty to Aer Rianta, which, in turn, might reduce Aer Rianta's cost of capital. On this basis, the Commission proposes that:-

> "*some proportion of the Commission's costs and expenses associated with airport charges regulation be payable directly by Aer Rianta from, for example, its non-aeronautical operations*"[1].

This paper sets out the reasons why we think that this approach is conceptually wrong and contrary to established regulatory practice, which would be to treat the Levy as a cost pass-through for the firm's regulated business. Section 2 demonstrates that the actual impact of economic regulation on a company's cost of capital is ambiguous. It is far from clear that regulation increases "certainty" as the Commission asserts. Even if the Commission is correct in asserting that independent economic regulation reduces the firm's cost of capital, this effect is already fully captured in Aer Rianta's allowed rate of return. Thus, if Aer Rianta has to absorb the costs of economic regulation via the levy, then in effect, the Commission will be double counting the "benefits" of economic regulation and imposing a double cost on Aer Rianta. Finally, recovering the costs of the Levy from Aer Rianta's non-aeronautical businesses would be distortionary, because it would place Aer Rianta at a competitive disadvantage relative to the non-regulated firms with which it competes.

[1] CP4/ 2002, page 13.

2. REGULATORY RISK AND THE COST OF CAPITAL

2.1. Introduction

This section examines recent expert analysis regarding the impact of regulatory regimes on the cost of capital. We distinguish between two different types of risk:-

- regulatory system risk, which examines the impact of the regulatory system on a company's cost of capital relative to a competitive market situation; and,
- regulatory intervention risk, which concerns the impact on the cost of capital of regulated companies following regulatory actions or "events".

Overall, this evidence suggests the impact of regulation on a company's cost of capital is ambiguous.

2.2. Regulatory System Risk

The earlier findings on regulatory system risk asserted that regulation provided a "buffering" effect on firms' profits by limiting both upside and downside earnings variability. This buffering effect occurs through price-reviews that ensure that permitted prices closely follow costs and thus mitigate earnings volatility of regulated companies. This is in contrast to a competitive market where earnings are more volatile in the absence of regulated prices.

However, more recent analysis has suggested that "buffering" effects might be more prevalent under rate of return regulation, as practised in the US. Under rate of return regulation, prices are set to ensure a fair rate of return on the basis of *ex post* outcomes, and prices tend to track costs closely. Whereas under price-cap regulation, where prices are set to ensure a fair rate of return on an *ex ante* basis, prices can significantly diverge from costs. This divergence of prices from costs is referred to as the *regulatory lag effect* and is a key source of earnings volatility.

The *regulatory lag* refers to the length of time between price reviews, or periodicity. For Aer Rianta the regulatory lag constitutes a five-year period[2]. The period between price reviews allows for prices to significantly deviate from costs, which in turn, permits a regulated company to earn less if it "underperforms" the efficiency targets embedded in the price-cap formula or if the efficiency targets are set at an unreasonably high level. By contrast, in a competitive market situation, we could expect prices to more closely track costs through a market based price adjustment process. The ability of regulated companies to under- or

[2] There is also the possibility of a mid-term review, although this is subject to conditions.

overperform before the correction of prices at the price review increases the volatility of earnings and their cost of capital.

The process whereby prices are adjusted can also increase volatility of returns. For example, the prevalent indexation mechanism in UK, whereby permitted prices are adjusted on the basis of a consumer price index, rather than input prices, exposes regulated companies to greater beta risk than a competitive situation where prices are adjusted according to input price changes.

The research also highlights actual aspects of the price review process that increase cost of capital vis-à-vis the competitive market situation, such as imperfect information on behalf of the regulator, lack of transparency or apparently arbitrary decisions. Such factors suggest that prices are not appropriately realigned with costs at the price review and this is a source of volatility.

In addition, regulated companies can incur political risk costs. Studies in the UK, where the regulators are empowered by statute and are regarded as operating relatively independently of the political process, have shown that there is a political risk factor that increases equity financing costs. Political interference can occur for example, through the instruction of government policy guidance and through the power of appointment and dismissal.

2.3. Regulatory Intervention Risk

The empirical literature that has examined regulatory intervention risk predominantly involves econometric "event" studies that relate regulatory actions and interventions to changes in the companies share price volatility or beta value.

The existing literature on regulatory risk and cost of capital effectively can be categorised into two broad areas:-.

- *Predictability of regulatory behaviour*:- There are a number of papers examining whether the use of a regulator's discretionary power, in the form of unpredicted regulatory interventions, increases the volatility of a companies returns and a regulated company's cost of capital. In general the evidence suggests that unanticipated regulatory actions or "events" increases the volatility of returns, and in some instances, beta risk. For example, studies regarding the impact of regulation intervention in the UK electricity industry found that in two-thirds of all regulatory "events" share volatility increased, with a significant degree of persistence in share price volatility following the event, i.e. the markets generally perceive regulatory interventions as increasing risk.

- *The price review process*:- The price control consultation procedures can be viewed as a source of uncertainty by utility firms due to what they see as arbitrary negotiation practices leading to problems in forecasting outcomes. On the other hand, some observers hypothesise that a company's beta follows a "saw-tooth" pattern over the

regulatory period, declining as the review approaches, since this offers an opportunity to pass through risk to consumers (in terms of a change in prices). Event studies have also shown that good regulatory conduct at the time of price reviews can be marked by a decline in volatility and a consequent decrease in risk.

2.4. Conclusions

More recent research findings on regulatory risk suggests that the lag between realignment of prices and costs can actually increase volatility, and hence the cost of capital. The actual price adjustment mechanism and the existence of political risk would also increase a regulated company's cost of capital.

The literature on regulatory intervention risk shows that arbitrary and unanticipated interventions by regulators can increase share price volatility and perhaps beta risk, with a certain degree of persistence following the regulatory event. However, there is also some evidence to suggest that a fair, rigorous and transparent price review process can decrease risk.

Overall, we conclude that the impact of regulation on a company's cost of capital is ambiguous. The existing literature does not suggest that there is a uniform impact of regulation on regulated companies; it appears to vary by regulator, by regulated sector and through time.

Our analysis shows that economic regulation has an ambiguous impact on a company's cost of capital and we conclude that the empirical evidence does not support the Commission's assertion that Aer Rianta "benefits" from regulation in the form of a lower cost of capital.

3. REGULATION AND AER RIANTA'S COST OF CAPITAL

3.1. Introduction

This section explains with reference to finance analyses and the Commission's own consultant's report why the effect of economic regulation on a company's cost of capital is already captured in Aer Rianta's permitted rate of return. This analysis unequivocally supports our key concern with the Commission's proposals that if Aer Rianta is not allowed to pass-through the costs of the levy to customers the Commission will effectively be double-counting for the "benefits" of economic regulation.

3.2. Cost of Capital Methodology

The commonly accepted approach to estimating cost of capital is to use the Weighted Average Cost of Capital (WACC) methodology. A company's WACC is equal to the weighted cost of equity and debt finance, with the weightings determined by the relative levels of debt and equity in the company's asset base, or the company's "gearing".

Within the overall WACC approach, the Capital Asset Pricing Model (CAPM) is widely used to estimate the company's cost of equity finance. The key tenet of CAPM is that investors hold a diversified portfolio of assets, and thereby diversify away the specific risk associated with assets. However, the portfolio still displays non-diversifiable risk, or *beta* risk, which is a measure of the co-movement of a particular asset or portfolio with the overall market portfolio. Beta risk is the only type of risk for which investors receive compensation in terms of higher returns.

Typically, beta risk is estimated by examining the share price behaviour vis-à-vis the overall stock market on a financial exchange. For non-quoted companies, such as Aer Rianta, it is common to look at "comparator companies" that share similar fundamental risk characteristics.

Research looking at the "decomposition" of beta risk into its component sources has shown that beta has three main components; demand risk; operating leverage; and, financial leverage (see for example, Morin[3]). Morin defines demand risk as the unanticipated variability in demand and prices caused by, inter alia:-

- macroeconomic conditions;
- regulation;
- competition; and,

[3] Morin R., "Regulatory Finance: Utilities Cost of Capital", Public Utilities Report 1994

- supply imbalances.

Operating and financial leverage reflect the extent to which these demand sensitivities are "magnified up" by the operating cost structure and the financial structure of the firm.

Thus, it is NERA's view, a view widely accepted in the financial literature, that beta risk as observed by examining share price performance reflects the riskiness associated with the regulatory regime.

3.3. Estimating Aer Rianta's Cost of Capital

This section discusses how the Commission's consultants and NERA addressed the issue of regulatory risk and other fundamental risk characteristics in estimating Aer Rianta's beta. The Commission's estimation of Aer Rianta's cost of capital is set out in a paper by Professor Colm Kearney and Elaine Hutson of Dublin City University[4]. As part of its wider submission to the Commission, Aer Rianta also commissioned NERA to determine its cost of capital[5].

Both Kearney and Hutson and NERA follow the CAPM approach to estimating the cost of capital of Aer Rianta, and use BAA's observable beta as representing the most appropriate comparator company to estimate Aer Rianta's beta risk. Both reports also discuss the nature of the risk captured by their beta risk estimate for Aer Rianta.

In its choice of comparators, Kearney and Hutson note that when using a comparator company to estimate an unlisted company's beta, it is necessary to make an adjustment for differences for the "business and financial risk" of the comparator and unlisted company. Financial risk refers to the differences in capital structure; this is the equivalent of financial leverage set out in the academic literature on beta decomposition. This is not the focus of this paper. The business risk is the relevant factor. Although the authors do not extensively describe what factors determine the business risk of a company, in their report they refer to competitive conditions, capex programmes, and passenger profiles as important fundamental determinants of beta risk. These factors broadly represent demand and cost risks, consistent with the academic theory in decomposing betas.

Kearney and Hutson conclude that "Aer Rianta's operational and business risks are not sufficiently different from BAA's to warrant significant adjustment to BAA's beta"[6]. Thus, the authors accept that the business risk captured in BAA's beta estimate appropriately reflects Aer Rianta's expected risk. If their definition of business risk includes the impact of the regulatory environment, as set out in the finance literature, then in effect Kearney and

---

4 Appendix VI of CP8; Aer Rianta's Cost of Capital, Report by Professor Colm Kearney and Elaine Hutson.

5 "Aer Rianta's Cost of Capital, Final Report", NERA.

6 Kearney and Hutson, op.cit., p161.

Hutson conclude that the impact of the regulatory regime is appropriately captured in their proxy beta estimate for Aer Rianta.

Like Kearney and Hutson, NERA state that when using a comparator company approach to estimating beta it is necessary to take into account differences in fundamental risk factors.

More specifically, NERA's report sets out the price-cap regulatory regime of BAA as an important determinant of choosing BAA as a proxy for estimating Aer Rianta's beta. This approach ensures that the impact of a price-cap regime on beta risk is appropriately reflected in our proxy for Aer Rianta's beta. NERA conclude that although there is scope for revising Aer Rianta's beta estimate (upwards) to reflect other differences in the operating environment of Aer Rianta relative to BAA (in practice it is impossible to have a perfect comparator), there is no scope for a "regulatory risk" adjustment. Again, the expected impact of the Irish regulatory regime on Aer Rianta's beta risk is appropriately captured in NERA's BAA proxy estimate.

In conclusion, the Commission's own consultants acknowledge that their estimate of Aer Rianta's cost of capital, based on BAA, reflects the expected business risk associated with Aer Rianta's operations. In finance literature, business risks include regulatory factors. NERA explicitly state that the regulatory regime is an important determinant of beta risk and partly on this basis select BAA, which operates in a similar regulatory environment to Aer Rianta, as the appropriate comparator company. Thus, this section clearly shows that the proxy beta estimate for Aer Rianta already reflects the impact of regulation on beta risk.

To impose the levy on Aer Rianta as set out in the Commission's consultation paper, without an appropriate cost pass-through mechanism, would effectively double-count for the impact of regulation on Aer Rianta's cost of capital.

4. THE APPROPRIATE SCOPE OF THE LEVY

In CP4 the Commission has also proposed that a proportion of the levy should be financed from revenues from Aer Rianta's non-aeronautical operations. This proposal is contrary to regulatory practice in other regulatory domains in Ireland and elsewhere, and is inconsistent with the promotion of economic efficiency.

If this levy is applied to non-regulated activities that operate in competitive markets, then this will place Aer Rianta at a competitive disadvantage vis-à-vis other suppliers. This can lead to distortionary price and output effects, and is contrary to the Commission's objective of promoting the efficient use of all resources by the airport authority as set in Section 33 of the Act.

Our survey of UK regulators demonstrates that regulatory best practice is to impose the levy on regulated activities only and treat this cost as a cost pass-through item.

- The UK Civil Aviation Authority (CAA) recovers the costs of regulation from "designated" (i.e. regulated) airports, and the airport operators recoup these charges through their regulated revenue by including them in their operating costs estimates that they submit to the CAA at the periodic review.
- The energy regulator, Ofgem, treats licence fees as a cost pass-through. The National Grid Company (NGC) price control includes an explicit adjustment to the level of regulated revenues equivalent to its liabilities in respect of licence fees. As such, NGC is able to set charges to recover the full costs of licence fees. Price controls for other companies that have their prices regulated by Ofgem also have explicit cost pass-through provisions.
- The Office of the Rail Regulator (ORR) allows Railtrack to recover the costs of licence fees. At periodic reviews, the forecast costs of licence fees are included in a group of costs called "non-controllable operating expenditure". These are then recovered from Train Operating Companies (TOCs) through the fixed component of track access charges.
- The UK water regulator, Ofwat, also allows for the costs of licence fees to be included within regulated revenues

There is therefore no theoretical basis for the allocation of any portion of the levy to non-regulated activities nor is there any basis in precedent