

OBSERVATIONS OF AER LINGUS ON SUBMISSIONS OF OTHER INTERESTED PARTIES ON A REVIEW OF THE DETERMINATION ON THE MAXIMUM LEVELS OF AIRPORT CHARGES

Aer Lingus welcomes the opportunity to comment on other parties' responses to the Commission for Aviation Regulation's consultation on a review of airport charges. In the following comments, we have decided to concentrate on the submissions of Aer Rianta as these submissions raise particular concerns about the scope of any review.

A. Scope of Review

The Aviation Regulation Act 2001 makes it clear that a determination issued by the Commission shall remain in force for a period of 5 years. It is further provided that the Commission may, 2 years after the making of a determination, review the determination as it sees fit if it considers that "there are substantial grounds for so doing." In view of the requirement that substantial grounds should exist for a review to take place, we believe that the scope of any such review should be strictly limited to those parts of the Determination which are affected by either a material change in circumstances or by significant new evidence which has come to light since the date of the final Determination. Moreover, the Commission might also take this opportunity to clarify certain elements of its Determination. The factors referred to by the Commission in its Notice of 16 April 2003 regarding a possible review, would indicate that the Commission is also of this view and we believe that this is the clear intention of the interim review provided for by the 2001 Act.

The Determination was the result of a lengthy consultation process with interested parties followed by an appeal process in which all interested parties had an opportunity to participate. Aer Lingus is therefore concerned that this review process is not used by any party as a means of reopening matters which have already been examined in detail and decided upon by the Commission. This interim review should not be used as a further appeal process.

We are therefore particularly concerned by the submissions of Aer Rianta who, we believe, are effectively seeking a full review of the Commission's Determination in its entirety. Indeed, if the Commission were to undertake a review on the terms suggested by Aer Rianta, this would have serious implications for the integrity of the entire regulatory process. In particular, Aer Lingus believes that a wide-ranging interim review would (i) weaken regulatory incentives for Aer Rianta's to improve its performance, (ii) damage the credibility and effectiveness of the Commission's decisions and (iii) reward Aer Rianta's focus on regulatory lobbying and litigation instead of seeking to improve its efficiency, the quality of its service provision and its customer service.

(i) A wide-ranging review would result in diminished incentives

As a monopoly, Aer Rianta must be controlled by regulation. However, instead of micro-management, the Commission rightly chose to implement the “CPI-X” incentive-based approach to regulation, as has been successfully applied by other regulatory bodies in Ireland, the UK and elsewhere.

Under CPI-X regulation, charges are adjusted infrequently, typically at five-yearly reviews. This represents a compromise between the objective of setting cost-reflective charges and providing incentives for costs to be reduced and risks managed. If airport charges are adjusted every time costs change (for example annually), charges will always be cost-reflective but the regulated company’s profits will never increase as a result of cost savings. Consequently, there are no incentives to reduce costs (or improve performance in other ways). Conversely, if charges are fixed for ever, incentives to reduce costs are very powerful (every cost reduction translates into an equivalent permanent increase in profits) but charges increasingly do not reflect costs and customers never see any benefit from the cost reductions.

Longer price control periods therefore provide stronger incentives but result in less cost-reflective charges. Longer periods also expose the regulated company to more risk. Some exposure to risk, of course, is to be welcomed as it provides an incentive to manage that risk.

Regulators have almost invariably chosen periods of four or five years as being an appropriate compromise. For example, we believe that the Commission for Energy Regulation uses such a period for its price controls on electricity transmission and distribution and, for the first time this year, gas transmission and distribution. In the UK, all utility regulators, including the CAA when setting airport charges, use four or five-year price control periods.

If, in its first interim review, the Commission were to accept that the Determination should in effect be reopened in its entirety, this will indicate that the relevant period is only two or three years and not the five-year period stipulated in Section 32(5) of the 2001 Act. As a result, incentives to reduce costs¹ and manage risk would be diminished.

Most regulators recognise that the possibility of an interim review is essential to prevent regulated utilities being exposed to exceptional circumstances such as excessive risk of bankruptcy or achieving excessive profits to such an extent as to damage the public credibility of the regulatory regime. However,

¹ One method of measuring incentives is to calculate the share of the present value of a unit cost saving made in the first year of a control period that accrues to the regulated business in additional profits. For a five-year period, this proportion is about 30%, for a two-year period just 13%.

to preserve incentives, such interim reviews should be expected to be rare and their scope narrowly defined.

As far as we are aware, no regulator in Ireland has ever re-opened a CPI-X price control review. In the UK, with its longer history of application of the price control approach, there have been more than 20 price control periods for network businesses in the air, water, energy, rail and telecoms sectors. We are only aware of regular interim reviews being carried by the UK water regulator (OFWAT). However, these reviews are strictly limited to updates on the detailed delivery of capital projects on a quarterly bases without effectively reopening the price control provision.

In only two other cases has there been a wide-ranging interim review. In particular, the electricity regulator re-opened the electricity distribution price control review in 1995, principally in recognition of the excessive profits that the distribution companies would make if the 1994 price control were not amended (as indicated by clear rises in share values on announcement of that first review). The CAA re-opened the price control review governing the National Air Traffic Control System's (NATS) en route charges in 2002, when faced with clear evidence that the company was experiencing a cash-flow crisis that would result in bankruptcy. In conclusion, regulatory practice would suggest that a wide-ranging interim review should only take place in exceptional circumstances of the kind outlined above. There are currently no such exceptional circumstances in the present case.

(ii) Re-opening previous decisions would reduce regulatory credibility, further damaging incentives

Incentives depend solely on the regulated company's expectations of the future, not on the past. If a regulator takes a decision that should provide incentives for efficiency and risk-management, that decision will have no effect if the company believes there is a reasonable probability that it will be overturned in the short-term future.

Several of Aer Rianta's stated grounds for a review seek to overturn previous decisions in this way, notably its request for the X-factor to be adjusted to reflect a revision of the Commission's benchmarking study. Benchmarking can provide particularly powerful incentives for improving efficiency because the company's cost targets are independent of its performance. However, efficiency targets based on benchmarking would have little effect if Aer Rianta's response is simply to spend two years (and significant funds which ultimately are likely to be paid for by airport users) preparing a technical challenge to the methodology in the hope of reversing the decision.

If the Commission accepts Aer Rianta's request to re-open its decisions in this way, it runs the risk that its future decisions will have no incentive power whatsoever.

(iii) A wide-ranging review rewards lobbying at the expense of operational efficiency

In the course of an extensive regulatory hearing in the U.S., one party commented that “Utilities can actually be rewarded more for justifying costs than for controlling them.” This seems to be an appropriate description of Aer Rianta’s current objective. Where the Commission had intended to step back and provide Aer Rianta with incentives to improve its performance (and reap rewards from doing so), Aer Rianta seems to regard its role as being to work for more favourable regulatory decisions. Having decided not to participate in the statutory appeal process and having been unsuccessful in a lengthy and costly judicial review process against the Commission, Aer Rianta is now seeking to re-open all of the significant arguments which were considered in detail and decided upon by the Commission in its Determination.

We would suggest that Aer Rianta’s efforts would be better deployed towards seeking efficiency improvements within the clear framework laid down by the Commission’s Determination. The air transport industry in Ireland – including Aer Lingus – should concentrate on reducing costs and improving services for its passengers, not on endlessly rehashing past regulatory debates.

B. Aer Rianta’s Stated Grounds for Review

Aer Rianta begins its submission by citing a wide range of supposed changed circumstances and flaws in the Commission’s Determination.

First, Aer Rianta refers to a short-term falloff in air traffic as a result of the global economic downturn, the events of 11th September, the Iraq war, SARS and Foot and Mouth. While we accept that the events of 11th September were unprecedented, Aer Lingus adapted to these events by restructuring and improving its efficiencies. As a result, Aer Lingus was in a position to meet the challenges of subsequent events such as the Iraqi war and SARS and substantially increased its passenger numbers during these events. We did not have the option of simply increasing prices to compensate as we operate in a competitive market. Similarly, we believe that Aer Rianta should have undertaken measures in the aftermath 11th September to improve its efficiencies beyond the targets set by the Commission in its Determination. Consequently, we do not accept that the Commission should now review its Determination to take account of the short-term falloff in air traffic as a result of 11th September.

The other factors cited by Aer Rianta do not constitute grounds for an interim review even if they are factually valid. In particular:

- Changes in airline operational and commercial models - accommodating changes in airline operations and commercial models seems to us to be a normal activity for Aer Rianta that should be carried out between charge

reviews without a need for a revision of charges. We note that Stansted Airport in the UK has seen dramatic growth in low-cost carrier operations without seeking an emergency interim review.

- A new dividend policy by the Department of Finance - the dividend policy of the Department of Finance is irrelevant. The Commission did not (and should not) set Aer Rianta's allowed return on the basis of its shareholder's wishes.
- Investment requirements to meet IATA standards - given that traffic growth has been lower than expected, it is difficult to see how the capacity requirements at Dublin can possibly be greater than those taken into account in 2001.
- Higher airport charges in the UK - the CAA's decision in the UK reflected the specific actions required of BAA and not a general tendency to provide airport operators with more money.

None of the above factors constitutes a change in circumstances that was not taken into account by the Commission at the time of the Determination and which cannot be managed by Aer Rianta as part of its normal business between regular charge control reviews.

Aer Rianta further advances arguments that the Commission's decision of 2001, as revised in 2002 following the decision of the Appeal Panel, was incorrect. We believe that the Appeal Panel was the appropriate process for Aer Rianta to question the accuracy of the Commission's findings and the interim review is not an appropriate forum for this purpose. For reasons best known to itself, Aer Rianta decided not to avail of the appeal process.

Aer Rianta specifically cites its disagreement with the Commission's decisions regarding:

- capital investment;
- asset valuation;
- traffic forecasts;
- security and insurance costs;
- commercial revenue assumptions;
- financial matters;
- efficiency targets and benchmarking; and

- the structure of the price cap (off-peak sub-cap at Dublin and sub-cap for Dublin airport overall).

We do not propose to examine all of the above issues in detail as we do not consider them to justify an interim review (with the exception of the structure of the off-peak sub-cap at Dublin airport where new evidence has been submitted). We do, however, wish to comment on two areas on which Aer Rianta makes detailed submissions (i) capital investment and (ii) efficiency analysis.

(i) Capital investment

In its original determination, the Commission did not allow for significant sums of capital investment that Aer Rianta had requested. The Commission's decision was made on two broad grounds:

- that Aer Rianta had not submitted adequate justification of its expenditure plans during that regulatory review; and
- that airport users – especially airlines – did not support the expenditure plans principally, again, because of inadequate information and consultation on Aer Rianta's part.

We do not know whether Aer Rianta intends to improve its performance in providing information to the Commission. Certainly, from our standpoint there has been no significant improvement in consultation by Aer Rianta. We have not been consulted meaningfully on any revised capital expenditure plans, especially at Dublin airport and we therefore believe that there has been no material change of circumstance that should lead to the Commission re-considering its decision.

Two major capital projects illustrate the manner in which Aer Rianta has ignored the Commission's clear guidance in this regard.

Cork Airport

Initially, Aer Rianta did carry out reasonably informative consultation on a new terminal at Cork. Aer Lingus and other airport users were consulted on the plans. However, we were unable to reach an informed judgement on whether the plans represented good value for money because Aer Rianta failed to cost the different options in terms of their effects on final airport charges. Aer Lingus attempted to estimate the charging implications for the main plan, but Aer Rianta would not confirm our calculations (and we did not receive a reply until five months after our request). Lacking the cost information and its effect on airport charges, airport users cannot make any meaningful judgement on whether the plans presented are desirable and therefore on whether alternatives should be considered. Consequently, we cannot regard the existing plans at Cork as having been approved by the airport users.

Dublin Airport

The situation at Dublin is even more unsatisfactory. Aer Rianta began a process of consulting on a “masterplan”, declaring that all previous consultation exercises were flawed. Aer Lingus welcomed the decision to start afresh in this way but we have become increasingly concerned that the process appears to be increasingly driven by Aer Rianta’s desire to press ahead with its plans for “Pier D” without any significant support from users. The Pier D proposal began, in our view, as an acceptable increment to contact stand capacity at reasonable cost. The initial design was no longer appropriate given enhanced security requirements post September 11th but Aer Rianta’s response has been to proceed with a proposal the cost of which is now many times that of the original estimate and which would result in only an additional three or four contact stands. As was the case with the proposed developments at Cork, Aer Rianta, despite being requested to do so, failed to outline the effect of Pier D on airport charges.

Both Aer Lingus and Ryanair have clearly stated that Pier D is not worth pursuing in this form but this view has been ignored, even though, as far as we are aware, these two airlines would be the only users of the facility. Any organisation that takes account of the views of its customers would have reconsidered its decision in the face of such a clear rejection. Moreover, there is now uncertainty as to whether the Government wishes to proceed with Pier D as it is re-examining the option of an independent terminal. Nevertheless, Aer Rianta has persisted in planning for the construction of a facility that is not regarded by its customers as cost-effective in its current form and is now seeking regulatory approval for an increase in airport charges to pay for it. This is a clear illustration of the airport operator’s refusal to change its plans in the face of stakeholder opposition, a refusal that makes any “consultation” exercise meaningless.

In our submissions to the 2001 review, our position was that capital expenditure plans should not be approved unless a meaningful consultation process was initiated, one that would enable users to understand the effects on airport charges of costed alternatives. No such process has been established and so our position in this regard remains unchanged.

(ii) Efficiency and benchmarking

Aer Rianta claims to have identified methodological weaknesses within the benchmarking exercise conducted by IMG for the Commission. They suggest that these weaknesses lead to efficiency improvements that are too demanding for Aer Rianta to meet. We have not assessed the validity of these claims. However, we do note that all benchmarking – and the regulatory decisions using benchmarking results – involves assumptions and the use of regulatory discretion. Some assumptions and decisions may have been relatively unfavourable to Aer Rianta, but others were, in our view, excessively

favourable. As Aer Lingus noted in its appeal against the Commission's initial determination, the benchmarking analysis used to set Aer Rianta's efficiency targets:

- excluded the most efficient (US) comparator airports from the analysis;
- did not take account of the likely presence of economies of scale as passenger numbers rise; and
- did not take account of the possibility of technical progress.

The Commission also exercised discretion in the application of the results arising from the benchmarking exercise. For example, it:

- chose not to set efficiency improvement target for Cork, despite a critical comment by the Aviation Appeal Panel²;
- decided to set the efficiency targets by comparing Aer Rianta's efficiency, not with the most efficient comparator airport, but with an average of other less efficient airports; and
- did not require Aer Rianta fully to eliminate the inefficiency found in the benchmarking study.

Overall, therefore, as we noted in our submissions to the Appeal Panel, in many ways the benchmarking analysis itself and the Commission's judgements on how to use it led to insufficiently stretching targets being set for Aer Rianta. We see no reason now to believe that the Commission's analysis led to an unachievable cost target. Even if some of Aer Rianta's criticisms of the benchmarking methodology are valid, any full review of the analysis would also have to consider methodological weaknesses that worked in Aer Rianta's favour.

In conclusion, we strongly urge the Commission not to weaken regulatory incentives and create regulatory uncertainty by re-opening a debate over the methodology of a benchmarking study which was examined in detail at the time of the Determination.

² "It is not clear to the Panel why no efficiency improvement targets were set for Cork Airport in the light of the need to provide 'cost-effective' airports in the future, since benchmarked airports could be expected to secure efficiency gains also and there would be improvements due to technical progress and economies of scale."

C. Conclusion

In conclusion therefore, the Commission should resist the attempts by Aer Rianta to use this review as a means of reopening issues which have already been considered in detail and decided upon by the Commission. The Commission should only review aspects of the Determination where substantial grounds exist for so doing, i.e. those issues which have been materially affected over the period of the Determination by a significant change in circumstances or by significant new evidence.