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# **Implications of the Aviation Appeal Panel Decision**

Report for Dublin Airport Authority

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## Executive Summary

This report, by NERA Economic Consulting for Dublin Airport Authority (DAA), examines a number of issues arising from the Commission for Aviation Regulation's document, *Consultation on the Decision of the 2006 Aviation Appeal Panel*. This follows DAA's appeal against the Commission's September 2005 determination, and the Appeal Panel's subsequent decision to refer the determination back to the Commission on three separate grounds:

- reductions in allowed capital expenditure (capex);
- adjustments to the regulatory asset base (RAB); and
- commercial revenues.

In its consultation document, the Commission expresses its apparent belief that the Appeal Panel restricted its focus to just one of the Commission's three statutory objectives. We believe this is a misreading of the Panel's decision, based on a single quotation taken out of context. In fact, there are many occasions when it is clear that the Panel was concerned with the totality of the Commission's objectives and, more generally, with the implementation of best practice regulation. Moreover, the Panel's conclusions are often based on its view that the Commission's approach is "arbitrary", "unreasoned", "illogical" or that it "systematically ignores other relevant factors and evidence". Clearly, these are not terms that are specific to any one of the Commission's objectives.

The Commission also refers to the 2003 High Court judgement in terms that could be interpreted, by some readers, as an endorsement of the Commission's general approach to regulation and thus at odds with the Appeal Panel's decision. This ignores the fact that a judicial review is focused on legal principles and process, rather than the merits of the Commission's analysis and decisions as considered by the Appeal Panel. Neither the High Court judgment nor the Commission's mistaken belief about the Panel's focus provide any basis for the Commission to do anything other than address both the letter and the spirit of the Panel's decision.

In relation to the first two issues referred back to the Commission (reductions in allowed capital expenditure and adjustments to the RAB), it is important to note that the Panel's decision is based on qualitative principles rather than quantitative analysis. The Panel does not state that the adjustments are too large, wrongly calculated or incorrectly applied. Rather, it states that these adjustments should not have been made at all. The only acceptable response to the Panel's decision is therefore a full reversal of all of these adjustments. Any other course of action would significantly undermine the perceived effectiveness of the existing appeals mechanism.

In relation to commercial revenues, the Panel is critical of the basis on which the Commission has overridden DAA's own projections and forecasts, stating that this "necessarily implies a disincentive for good faith conduct by DAA and is out of line with best practice incentive regulation". It suggests that the Commission should have "very clear evidence" before substituting its own projections, which in this case the Panel believes were based on a "simpler, selective and ad hoc" approach. Instead, the Panel states that "a more analytical and bottom-up approach" should have been adopted. Given the limited time available, and the fact that DAA's commercial revenue forecasts for the period of the first Determination

were very close to the actual outturn figures, we believe the most appropriate course of action is for the Commission simply to adopt DAA's projections.

In addition, within its report, the Panel sets out a number of general regulatory principles, for example the basis on which retrospective adjustments might be considered legitimate, the proper role of the regulator in relation to capex allowances, or the conditions under which a regulator might be justified in disallowing expenditure from the RAB. The Commission should respond to the Panel's decision by adopting these principles in its future analysis, as well as dealing with the immediate consequences for its September 2005 determination.

Finally, we note that the Panel expressed a number of concerns in its report, drawing attention to cases where the Commission had adopted a selective approach, where its actions might be interpreted as biased against the adequate remuneration of capital, or where it might signal a negative regulatory attitude to the investment community. The way in which the Commission reacts to the Panel's decision – which after all represents an independent and informed judgement – will be important in demonstrating that its approach is not biased or selective. If the Panel's criticisms are not addressed by the Commission, both in its immediate response to this decision and in its subsequent approach to future determinations, there is a danger that such cases of negativity and selectivity could appear to potential lenders (and, if relevant, investors) to be examples of a more straightforward bias against DAA.

## **1. Introduction**

This report, by NERA Economic Consulting for Dublin Airport Authority (DAA), examines a number of issues arising from the Commission for Aviation Regulation's consultation paper CP3/2006, *Consultation on the Decision of the 2006 Aviation Appeal Panel*. This follows the Panel's decision on an appeal lodged by DAA against the Commission's September 2005 determination of airport charges at Dublin Airport (which was set out in document CP3/2005).

The Panel considered five separate grounds of appeal, some of which covered several different issues (which the Panel also ruled on separately). The Panel referred the determination back to the Commission on three of these five issues (reductions in allowed capital expenditure, adjustments to the regulatory asset base, and commercial revenues), but not on the other two (pensions and cost of capital/financeability). In addition, the Panel's report makes a number of general comments on the Commission's analysis and approach, and a number of helpful suggestions on principles that should be applied in future.

In Section 2 we consider the relevance of the Panel's decision, mainly in response to some of the Commission's statements in CP3/2006 that could be interpreted, by some readers at least, as casting doubt on the importance of the Panel's decision. Section 3 then addresses the key principles established by the Panel's decision, focusing on their implications for both the Commission's immediate response to the decision and, more generally, its future work. Finally, Section 4 discusses some of the more specific aspects of the way that the Commission appears to be responding to the decision.

## 2. Relevance of the Panel's Decision

### 2.1. The Commission's Statutory Objectives

The Commission appears to believe that the Panel based its decision on a restricted set of the Section 33 objectives – that is, it focused on the objective of enabling DAA to operate and develop Dublin Airport in a sustainable and financially viable manner, but ignored the objectives of facilitating the efficient and economic development and operation of Dublin Airport that meets the requirements of current and prospective users, and protecting the reasonable interests of current and prospective users in relation to Dublin Airport.

The Commission expresses this belief in an explicit fashion on page 5 of CP3/2006, stating:

“the Commission is of the view that its statutory responsibilities do not permit it to restrict its focus, as the Panel appears to have done, to the single objective of sustainability and financial viability”.

This statement appears to us to be a clear and surprising misreading of the Panel's decision. It appears to be based on a single quotation, taken out of context. In fact, this statement was made in relation to the Panel's decision about the process that it should follow, based mainly on the fact that (apart from Failte Ireland's “observation”) DAA was the only body to appeal the determination and the grounds on which DAA's appeal was based.

Indeed, this statement appears in a section of the decision clearly headed “The Procedures followed by the Panel”, which itself follows a lengthy discussion of the 2004 Act (including all three objectives plus the relevant factors) and the role of the Panel. Apart from this isolated statement, which relates to the Panel's procedures rather than the basis on which it has made its decision, there is no other suggestion in the Panel's decision that it has restricted its focus. The only other case where the Panel's decision refers to this particular objective is in relation to the specific question of financeability, where the focus on this objective is appropriate and indeed entirely consistent with the Commission's own approach.<sup>1</sup>

On the contrary, there are many occasions when it is clear that the Panel is concerned with the totality of the Commission's objectives, and more generally with the implementation of best practice regulation. In relation to the clawback of capital expenditure (“capex”), for example, the Panel's criticism of the Commission's approach is based on its inconsistency with “the ‘standard’ approach to CPI – X regulation which the Commission indicates that it is seeking to follow”.

More generally, many of the Panel's decisions are based on its view that the Commission's approach is “arbitrary”, “unreasoned” or “illogical”, or that it has adopted an approach that “systematically ignores other relevant factors and evidence”. These are not terms that are specific to any one of the Commission's objectives. It is simply not appropriate for the Commission to attempt to dismiss such statements by claiming that the Panel had too narrow

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<sup>1</sup> We note, for example, that the Commission's analyses of financial ratios, accelerated depreciation, DAA's credit rating, the cost of capital and similar issues appear in CP2/2005 and CP3/2005 under sections entitled “Sustainability and Financial Viability” or similar.

a focus, and it is regrettable that the Commission has chosen to cast aspersions on the applicability of the Appeal Panel's analysis in this way

The Commission has stated very clearly that it interprets its objectives as requiring it to promote allocative, productive and dynamic economic efficiency (see, for example, section 7 of CP3/2005). Regulatory decisions that are arbitrary, unreasoned and illogical, or approaches that “systematically ignore” relevant factors and evidence, clearly contravene all of these requirements.

The Panel's decision is therefore completely relevant to the Commission's objectives, and to fail to take proper account of the Panel's clearly expressed views would seriously undermine the existing appeals mechanism.

## **2.2. The Irrelevance of the High Court Judgement to the Decision**

In Section 3 of CP3/2006, the Commission makes a further regrettable statement that could be interpreted as casting aspersions on the validity of the Panel's decision:

“The Commission notes that certain comments made in the Appeal Panel Decision echo arguments made in the course of litigation between the Commission for Aviation Regulation and Aer Rianta cpt. and disposed of in the course of a comprehensive 2003 High Court judgement in favour of the Commission's approach to airport charges regulation.”

Unfortunately, the Commission does not make any further comment on this statement, or explain the implications it believes this has for the question of how it responds to the Panel's decision.

Whatever the Commission's intention by including this statement in CP3/2006, it could be interpreted by some readers as suggesting that, because the High Court found in the Commission's favour, this was in effect an endorsement of many of the detailed aspects of the Commission's determination. The ambiguous nature of the Commission's drafting, and in particular the reference to the Commission's “approach to airport charges regulation” could easily give readers of CP3/2006 a misleading impression of the nature of the High Court judgement.

To be clear, the High Court judgement and the recent Panel decision should not be viewed as providing two conflicting opinions on a set of common questions. The existence of the High Court judgement does not in any way diminish the relevance and importance of the Panel's decision, or allow the Commission the latitude to ignore some or all of the Panel's conclusions.

While the Appeals Panel and a judicial review are alternative possible ways of challenging a determination by the Commission, they are very different procedures:

- the Appeals Panel is a panel of relevant experts that considers particular aspects of the determination on its merits. The outcome is that the Panel may refer the determination back to the Commission;

- judicial review provides a route to challenge the validity of a determination, so that the outcome may be that the Court deems a determination to be invalid or states that it ought to be quashed. But this is a formal legal process, and in relation to approach adopted or the analysis carried out by the Commission (rather than questions of legal processes and powers), the burden of proof is very high indeed. There must be substantial grounds for contending that the Commission has acted unreasonably.

While there is no definitive view of what would constitute “unreasonable” behaviour, we note that, at least in the area of economic regulation, it is extremely rare indeed for a judicial review to be successful on grounds of the analysis underpinning a regulatory decision. Where judicial reviews have been successful, these have been mainly on questions of due process – both legal questions (eg whether the regulator complied with the relevant legislation) and non-legal questions (eg if the regulator consistently ignored substantial points made by consultation respondents and could not produce any evidence of having properly considered the arguments put forward).

In summary, because the focus of a judicial review is on legal principles and process rather than an appeal on merit, we do not believe that the Commission’s statement about the 2003 High Court judgement, as reproduced above, has any relevance at all to the question of how it should respond to the Panel’s decision.

### **3. Key Principles Established by the Panel**

#### **3.1. Introduction**

In its publications, the Commission often refers to its objective to pursue “best practice regulation”. Indeed, it uses this objective to argue, in CP3/2006, that it is necessary for it to consult with airport users.

We address the specific issue of consultation in Section 4.1 below. More generally, however, it is important to recognise that “best practice regulation” should encompass the quality of regulatory decision making as well as process issues such as consulting with users and providing information about the Commission’s decisions.

The Panel’s decision is critical of a number of decisions taken by the Commission, which are variously described as “unreasoned”, “arbitrary”, “illogical”, “simplistic” and so on. Elsewhere, the Panel “finds it very difficult to understand” the basis for some decisions. We would argue that the standard of analysis and decision-making is a far more important aspect of best practice regulation than the process issues that the Commission appears to be principally focussed on.

In several places, the Panel also sets out a number of principles or decision-making criteria that it believes are appropriate. If the Commission is serious in its objective of pursuing best practice regulation, then it is important that it pays close attention to these principles, which have been suggested by an independent and informed panel, in order to conform with both the letter and the spirit of the Panel’s recommendations. The most important of these additional principles, which we endorse and think would be very useful for the Commission to adopt, are highlighted in boxes in the following sections.

More generally, a further important reason for the Commission to adopt the Panel’s recommendations is to avoid undermining the perceived effectiveness of the existing regulatory appeals mechanism. An effective appeals mechanism is an essential component of a well-functioning regulatory framework, and it is especially important in cases where lenders (or investors) may have reason to fear that future decisions could be arbitrary, illogical or based on a poor standard of analysis. Potential lenders and investors must have confidence that, among all the other risks they face, the regulatory framework will treat the company fairly and will give it a fair opportunity to recover its costs and earn a reasonable rate of return. This confidence could easily be eroded if decisions that have been identified (by independent experts) as arbitrary, illogical or unreasoned are nevertheless allowed to stand, or if the Commission does not take action to remedy the other shortcomings identified by the Panel.

#### **3.2. Use of Projections Prepared by Regulated Firms**

A common theme running through several sections of the Panel’s decision is the low burden of proof that the Commission appears to have adopted when deciding to override DAA’s own projections or forecasts. Indeed, the Panel notes a number of specific cases where it believes the Commission has overridden DAA’s projections on the basis of high level or simplistic calculations, benchmarking exercises that are insufficiently robust, and other inappropriate comparators.

In part, this seems to reflect the Commission’s approach to the potential problems associated with asymmetric information. In the context of investment costs, the Panel expresses its concern (in para 6.3.7) about the Commission’s apparent belief that DAA “will always significantly over-estimate” its costs, and it draws attention to the Commission’s apparent procedure of “making relatively arbitrary, downward adjustments to costs, with the implied intention of correcting for assessment bias”. Importantly, the Panel goes on to note that:

“This necessarily implies a disincentive for good faith conduct by DAA and is out of line with best practice incentive regulation” (para 6.3.8).

Instead of continuing to make arbitrary adjustments to DAA’s projections or replacing them with high-level estimates from other sources, the Panel states (in this case in relation to investment costs, though clearly with much wider applicability):

“A more appropriate regulatory response to the information problem would be to seek more vigorously to verify the information provided, discuss and consult on alternatives and only substitute the Commission’s own reasoned alternative when there is very clear evidence of assessment bias” (para 6.3.8)

Importantly, similar issues also arise in relation to commercial revenues, where the Panel notes a “common argument of principle”, which is that “the Commission has consistently ignored or set aside relevant evidence in favour of a simpler, selective and ad hoc approach” (para 6.6.4).

The Panel also draws attention to the fact that, despite the Commission’s “significant over-projection” of commercial revenues at the time of the previous determination,

“there is no discussion ... of the possible reasons for that particular outcome. In our view, this omission is unlikely to inspire confidence that the Commission’s commercial revenue projections on this occasion will be significantly more accurate than in the past” (para 6.6.4)

To address these problems, the Panel concludes (para 6.6.7) that

“a more analytical and bottom-up approach to commercial revenues, based upon an assessment of a wider body of relevant information and evidence, should have been taken by the Commission”.

These issues are important, since the Panel concludes that there are sufficient grounds to refer the Commission’s decision on commercial revenues. As the Panel is critical of the “somewhat simplistic and mechanistic” approach used to estimate property and car parking revenues, and other aspects of what the Panel characterises in general as a “simple approach”, this raises the question of what projection of commercial revenues the Commission should adopt instead.

Clearly one option is for the Commission to adopt DAA's own projections. This would be consistent with the more analytical and bottom-up approach, based on a wider body of relevant information and evidence, that the Panel argues that the Commission should have used. And whereas the Commission has been reluctant to use DAA's own projections in the past, as noted above the Panel is critical of the Commission's approach in this regard.

While some aspects of regulated firm's forecasts are often subject to extensive analysis and challenge by regulators, especially in relation to factors such as cost efficiency assumptions, it is certainly not unusual for regulators to review projections provided by the firms themselves, conclude that they appear to be fit-for-purpose and then adopt these projections for the purpose of calculating the price cap.

Specifically in relation to commercial revenues at regulated airports, the UK Competition Commission (CC) and Civil Aviation Authority (CAA) generally review the projections prepared by BAA (for its three London airports) and Manchester Airport, and then have very often accepted either the projection of total commercial revenues or the underlying assumptions of commercial revenue per passenger.<sup>2</sup> Indeed, in the most recently completed price review, the CAA initially adopted a projection of commercial revenues which was lower than that put forward by Manchester Airport, based on current profit levels rather than those that Manchester Airport's consultants had suggested were achievable. Even though the CC subsequently suggested a higher projection, the CAA retained its original, lower projection, which had the effect of reducing the value of "X" by about two percentage points in each year. The situation for BAA's London airports was more straightforward – the CC commissioned consultants to review BAA's commercial revenues. The consultants broadly supported BAA's approach, and the CC concluded that there was "no evidence to suggest that we should adopt a different assumption to that of BAA".

In the previous charges review for each of the airports, the situation was slightly more complex because projections of commercial revenues were significantly affected by the projected loss of duty-free and tax-free sales for EU passengers. And in the years before that, the CC's predecessor, the Monopolies and Mergers Commission, sometimes accepted the airports' projections of commercial revenues (eg for Manchester in 1987 and BAA in 1991), but on at least one other occasion decided to adjust the airport's projections (for Manchester in 1992).

In relation to projections of DAA's commercial revenues, therefore, the Commission would certainly not be acting out of line with standard regulatory practice if it accepted DAA's projections without adjustment. In view of the Panel's comments above about the grounds on which it is appropriate to override the regulated firm's own projections and the approach that the Commission should have adopted, the limited time now available and the fact that DAA's commercial revenue forecasts for the period of the first Determination were very close to the

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<sup>2</sup> CAA has sometimes provided its own traffic forecast, which imply an automatic adjustment to projected commercial revenues.

actual outturn figures, we believe the most appropriate course of action is likely to be simply to adopt DAA's projections.<sup>3</sup>

### **3.3. Adjustments to Capex Allowance and the RAB**

The Panel reviewed several adjustments that the Commission has made to capex allowances and the regulatory asset base (RAB). These included:

- two reductions in DAA's future capex allowance in relation to the Pier D and Terminal 2 projects;
- a "clawback" of expenditure that had been included in previous determinations in relation to Pier D; and
- the Commission's decision to continue excluding a portion of the costs of Pier C from the RAB.<sup>4</sup>

The Panel decided to refer the determination back to the Commission in relation to all of these cases.

In addition to its conclusions, the Panel's analysis includes a number of clear statements of its views in relation to the regulatory treatment of capex in general, and the conditions under which an adjustment to capex allowances or the RAB might be appropriate. These are summarised below.

One important general aspect of the Panel's conclusions, however, is that its decisions in this area are based on qualitative principles rather than quantitative analysis. The Panel does not state that the adjustments are too large, wrongly calculated or incorrectly applied. Instead, the Panel states that these adjustments should not have been made at all.

In relation to the general approach to capex, the Panel's view is that:

"the details of design and configuration, including pier width, are not essentially a matter for the Commission as regulator to adjudicate on. These details are a matter principally for DAA, subject to consultation and discussion with its owners and customers" (para 6.3.4).

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<sup>3</sup> A further possible consideration is that any new analysis, even if it were based on "a more analytical and bottom-up approach" and provided "very clear evidence" against DAA's own projections, might be in breach of the Commission's stipulation that any analysis carried out can only relate to the information that the Commission had before it at the time of consultation with interested parties (see Section 4.2).

<sup>4</sup> While the Commission made this adjustment in its very first determination, in 2001, it raised the question in CP2/2005 of whether this adjustment should now be reversed (and indeed gave reasons why this might be appropriate). However, CP3/2005 stated that the Commission had decided to continue excluding these costs from DAA's RAB.

The Panel then states the conditions under which it considers there might be a role for the regulator in relation to such details (para 6.3.4). These are either:

- in the event of a major disagreement, for example in the case of Pier D if users had expressed a clear preference for a smaller facility; or
- in the event that the budgeted costs of certain aspects of design and configuration appeared manifestly or excessively profligate.

These principles are based on the Commission's current approach, where the regulatory settlement "is a relatively broad one, with performance requirements not spelled out in detail". The Panel notes that alternative approaches are possible, for example based on a more contractualised system with revenue allowances linked to defined events or outcomes. But any move to introduce such a system would need to be part of a more general change in the Commission's approach to regulation, and the Panel also notes the complexities that are associated with such systems.

In its analysis of the clawback of projected expenditure on Pier D, the Panel notes (para 6.4.5) that

"It is also a key principle of the standard CPI - X approach that price or charge caps, once determined, are 'pre-determined' for the relevant period, meaning that, although the charges may be adjusted (e.g. to reflect inflation) they will be adjusted in ways that cannot be materially influenced by either the regulator or the regulated undertaking".

The Panel then states that clawback violates this key principle, as its economic effect is equivalent to a retrospective, discretionary adjustment of charges that were meant to be pre-determined.

The Panel states (para 6.4.7) that such clawback could properly be considered legitimate:

- if DAA had deliberately misled the Commission; or
- if DAA's performance can be characterised as being akin to negligence.

The defining feature of such circumstances is that there is "some manifest deficiency" in DAA's conduct, such that its performance falls to "an unacceptably low level".

The Panel does not contend that any of these circumstances applied in the case of Pier D, and therefore referred this decision back to the Commission.

In relation to the disallowance of capex from DAA's RAB, the Panel notes (para 6.4.12) that this "can potentially create material, adverse regulatory risk and uncertainty".

The Panel states its belief (para 6.4.13) that the circumstances under which RAB disallowances might legitimately be justified are similar to those discussed in relation to clawback (see above).

RAB disallowances are only justified “in the event of some manifest deficiency in the performance of the regulated company, such as would be considered outside normal commercial parameters”.

After noting that it “can see no evidence of such conduct on the part of DAA”, the Panel then expands on this principle, stating that

“Only if DAA can be shown to have strayed outside the bounds of reasonable conduct or made an unreasonable decision about the type of capital expenditure incurred should there be any ‘disallowance’ issue for the Commission to consider”.

This statement also highlights the fact, noted above, that the Panel’s view is based on qualitative principles. Thus it states that only in the circumstances it describes should there be “any” disallowance issue to consider. The Panel does not argue that the Commission disallowed “too much” of DAA’s RAB. Rather, it states clearly that, unless DAA has behaved unreasonably, there should have been no disallowance at all.

The only way that the Commission can reflect the Panel’s decision, therefore, is fully to reinstate the previously disallowed expenditure on Pier C. A partial reinstatement is not an option, as this would be inconsistent with the clearly stated views of the Panel. Very similar considerations apply with equal force to the other adjustments described in this section. A full reversal of all of these adjustments is the only acceptable response to the Panel’s decision, and any other course of action would significantly undermine the perceived effectiveness of the existing appeals mechanism.

### **3.4. Implications for Financeability**

Although the Panel decided that sufficient grounds had not been established to refer to Commission’s decision in relation to financeability, it is important to note that this view was based on the assumption that other parts of the Panel’s decision, and indeed the wider problems that it identified in relation to the Commission’s approach to regulation, are addressed.

In relation to the cost of capital, which the Panel views as the main proposition in DAA’s financeability arguments, the Panel’s conclusions are qualified as follows.

“The only proviso is that, if the concerns we have raised in other parts of this Decision are not addressed, capital markets might come to require higher debt premia to compensate for perceived asymmetries in regulatory risk. However, the Panel considers that the better way to approach this issue is to address the fundamentals, which relate to regulatory certainty and regulatory risk, rather than to make ad hoc adjustments to the cost of capital estimate” (para 6.7.12)

This demonstrates the importance of the Commission taking action to “address the fundamentals”. We would argue that such action must include both amending its determination in a way that is fully consistent with both the letter and the spirit of the Panel’s decision, and also taking note of the more general principles discussed above when making future determinations (including the specific reviews focused on DAA’s capex and on pensions costs). If the Commission does not act in this way, then we would argue that the Panel’s decision should no longer be seen as supporting the cost of capital used for the determination.

The Panel also refers to the Commission’s suggested use of “accelerated depreciation” as a means of addressing short-term financeability problems. In its response to CP2/2005, DAA argued that action should be taken to address the underlying cause of poor financeability, rather than adopting a short-term solution that might compound the difficulties in future control periods.

Indeed, we would argue that the correct interpretation of the Panel’s decision in relation to financeability/cost of capital is not that there is no financeability problem to be addressed. Rather, to the extent that there may be a financeability problem, the Panel’s decision suggests that this reflects faults with other parts of the determination rather than a specific problem with the cost of capital.

### **3.5. Possible Perceptions of Bias**

Finally, we note that there are a number of instances where the Panel draws attention to the Commission’s selective decision-making and the negativity implied by its approach. These include:

- concerns about the Commission’s views on the implications of asymmetric information, resulting in an apparent belief that all projections supplied by DAA need to be adjusted, even if there is little or no robust evidence to justify such an adjustment (paras 6.3.7 to 6.3.8);
- the risk that capital markets will, on the basis of the Commission’s reasoning, “interpret regulatory policy as biased against the adequate remuneration of capital” (para 6.3.13);
- the “very selective” way in which the Commission appears to have applied its approach to “clawback” (para 6.4.10);
- the concern that this selective approach “may, via retrospection that is focused only on investment activity, signal a rather negative regulatory attitude to CAPEX to the investment community” (para 6.4.10);
- the risk that unless disallowances of capex from the RAB are guided by credible and legitimate principles, “they will be perceived as a form of capital expropriation” (para 6.4.11)
- the Panel’s view that the Commission’s approach to projecting future commercial revenues “systematically” ignores other relevant factors and evidence” (para 6.6.6); and
- the Panel’s view that, if its concerns expressed in other parts of the decision are not addressed, “capital markets might come to require higher debt premia to compensate for perceived asymmetries in regulatory risk” (para 6.7.12)

Each of these concerns is important in its own right, and indeed the Panel notes the danger that the Commission's reasoning, in one case, could be interpreted as a "bias" against the adequate remuneration of capital. Perhaps the greater danger, however, which is suggested in the last bullet, is that the cumulative impact of a number of individual decisions could be perceived as evidence of a more systematic bias on the part of the Commission.

The Panel's concern about the Commission's approach is a valid one, and the way in which the Commission reacts to this decision – which after all represents an independent and informed judgement – will be important in demonstrating that its approach is not biased or selective. If the Panel's criticisms are not addressed by the Commission, both in its immediate response to this decision and in its subsequent approach to future determinations, there is a danger that such cases of negativity and selectivity could appear to potential lenders (and, if relevant, investors) to be examples of a more straightforward bias against DAA.

## 4. Implementation Issues

### 4.1. The Role of Consultation

In CP3/2006, the Commission states that, in the interests of best practice regulation, it is necessary to consult with and receive views on its response to the Panel decision not only of DAA but also of airport users.

As general principle, this statement is entirely reasonable. In the context of the Panel's decision, however, the arguments for consultation are much weaker. In particular:

- the Panel's decision represents an informed and independent view of the issues raised. The effectiveness of the appeals mechanism could be seriously undermined if the Commission were to disregard the Panel's view, even just in part, on the basis of subsequent submissions from parties that are not independent and that have a direct interest in seeing airport charges either increased or decreased. The burden of proof that the Commission applies when considering the relevance of consultation responses therefore needs to be very high;
- in many cases (notably the reductions in allowed capex and the adjustments to the RAB), the Panel's decision is based on a qualitative view that the Commission's approach is "arbitrary", "unreasoned", "illogical" and so on, and/or that it is inconsistent with either best practice regulation or the "standard" approach to CPI-X regulation. In such cases, it is far from clear what views and arguments could be advanced, especially from the parties directly affected, to challenge a qualitative (rather than quantitative) decision by independent experts;
- even where implementation of the Panel's decision might be viewed, rightly or wrongly, as a quantitative rather than a qualitative decision (notably the projections of commercial revenue – see also the discussion in Section 3.2), the Commission should now have regard to the Panel's guidance on best practice regulation and its criticisms about the poor quality of evidence and the low burden of proof that the Commission has adopted when overriding DAA's own detailed forecasts. It is doubtful that any evidence produced by third parties within the timescale allowed for the Commission's consultation will be sufficiently robust as to justify an adjustment to DAA's forecasts on a basis that would be consistent with the Panel's guidance;
- finally, the Commission's apparent restriction on the information that can be used at this stage in the process, as described in the next section, would appear to limit further the scope for any party to provide a consultation response that might shed significant new light on the conclusions clearly expressed in the Panel's decision.

### 4.2. Use of Relevant Information

CP3/2006 contains the following statement:

"It is also important to point out that any analysis arising from this referral can only relate to the information that the Commission had before it at the time of consultation with interested parties."

While the Commission then moves on to explain the implications of this statement for capex and the potential for a further review once DAA's investment programme is finalised, this restriction on the information that can be used is presented as a general requirement that presumably applies to all areas of the Commission's review.

It is surprising, therefore, that this restriction is not repeated at the various stages later on in CP3/2006 where the Commission "requests" interested parties to give their views on whether it should vary the determination, and indeed "encourages" representations setting out cogent arguments and, "where possible", supporting evidence.

We do not understand this apparent inconsistency. Equally, however, for the reasons set out above, we find it difficult to imagine what views, arguments or evidence could be supplied by interested (but not independent) parties such that it might have a material impact on the Commission's appropriate response to the clearly-stated decision of the independent and informed Appeals Panel.

### **4.3. Future Reviews**

Finally, it is important to note the areas where the Panel has suggested that the Commission should carry out further reviews in future, in particular in relation to:

- DAA's capex programme. Para 6.3.13 reports that the Panel considers that "the Commission should commit to review its determination on Terminal 2 issues immediately following the report of the independent expert group"; and
- pensions – this is consistent with the principle, that is clearly signalled in the Commission's determination, that "DAA pension costs should be recovered, and that the approach taken this time around, is by design, a partial one" (para 6.5.3). The Panel explicitly notes the Commission's "commitment" to review these matters, and states that it "would be strongly in favour of such a review at an appropriate stage".

It is important that these reviews are carried out, and on a basis consistent with the Commission's previous statements about them (including its acceptance of the principle that DAA pension costs should be recovered), because the likelihood of these reviews appears to have been an important factor that affected the Panel's decision on pensions and its comments elsewhere in the decision. In the case of pensions costs, moreover, the Commission should indicate now either the expected timing of its review or the events that would trigger such a review.

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