
Aer Rianta Response
To Commission Paper CP4/2003:

Notice by the Commission for
Aviation Regulation Relating to the
Determination on the Maximum
Levels of Airport Charges Setting Out
the Issues to be Reviewed and
Seeking Representations from
Interested Parties or the Public

8th December 2003

AerRianta

TABLE OF CONTENTS

EXECUTIVE SUMMARY	3
STRUCTURE OF SUBMISSION	6
1. ITEMS EXCLUDED FROM THE INTERIM REVIEW	7
CONCLUSION	13
2. MATTERS ARISING FROM THE ITEMS ADDRESSED BY THE COMMISSION IN CP4/2003 15	
2.1 MATTERS RELATING TO 9/11	15
2.1.1 <i>Inconsistent Treatment of Passenger Forecasts in CP4/2003</i>	15
2.1.2 <i>Treatment of Security Costs</i>	17
2.2 MATTERS OF COMPUTATION	20
2.2.1 <i>Security Adjustment in Prior Period</i>	20
2.2.2 <i>The Commission's Projection of Incremental Security Operating Costs</i>	21
2.2.3 <i>Incorrect Calculation of Taxation Charge</i>	22
3. FINANCIAL ASPECTS OF CP4/2003	24
<i>Inaccurate Representation of the Business</i>	25
<i>Financial Viability Test</i>	27
APPENDIX 1 AER RIAN TA SUBMISSION 4TH JULY 2003	30
APPENDIX 2 COMPARISON OF KEY FINANCIAL MEASURES - CONFIDENTIAL	31

EXECUTIVE SUMMARY

Aer Rianta is making this submission in response to the Commission's invitation, in accordance with statutory provisions, to make representations in respect of the proposals set out in CP4/2003.

Aer Rianta is disappointed at the Commission's draft interim proposals for a further reduction in the maximum levels of airport charges. This is particularly significant in the case of Dublin Airport where, if the Commission's proposals are implemented, the sub cap will reduce to an average yield of €4.89 per passenger for 2004, i.e. a further reduction in charges that are already the lowest of any comparable airport in Europe.

Sufficient investment is necessary to ensure that Dublin Airport has the infrastructure to meet growth in passenger numbers, and to ensure that customer facilities are appropriate for an international airport in a European capital city. This will require an increase in the low level of airport charges at the Airport.

Implementation of the low level of the price cap proposed in CP4/2003 will mean that Aer Rianta will not generate sufficient cash flows in the context of the sustainable and profitable operation of the airport as required by Section 33(b) of the Aviation Regulation Act, 2001. Significantly, Dublin Airport will not be able to provide the level of investment in the airport facilities required to meet the current and prospective needs of users. As a consequence, significant capacity constraints will arise, resulting in congestion, delays, lower service levels and increased costs. This will eventually constrain capacity for new airlines and additional routes and services out of Dublin Airport. This will have negative implications for the Irish economy, particularly in relation to trade, tourism, inward investment and employment.

Though the requirements of existing airline users must be addressed there is also a pressing need to give a balance to the requirements of other airport users such as passengers, ground handlers and other service providers, airport staff and potential future airline operators. In this context, there

is a significant divergence between the position of the Commission for Aviation Regulation in relation to the level of future investment required at Dublin Airport and the assessment by the company of the level of investment required to ensure the proper development of the Airport to meet the needs of current and prospective users and local and national economic needs. It is also important for economic development to balance the shorter time focus of airlines with the longer time horizon for investment in key infrastructure at the airports. The determination for airport charges for Dublin Airport provides for an investment of less than €3.00 per passenger in airport infrastructure over the regulatory period. This compares with investments levels in other international airports of between €6.00 and €10.00 per passenger. Amsterdam, Schipol is investing €1.45billion, BAA €8billion and Aéroports de Paris €2.5billion compared with Dublin Airport investment allowed by the Regulator for five years of €235million. There are serious long-term consequences for Irish aviation policy if Dublin Airport is starved of investment by the Commission.

In a single till environment, additional aeronautical revenue must be forthcoming to remunerate investment as extremely challenging commercial revenue growth is already built into the Determination on the maximum level of airport charges that may be levied. A reasonable return is necessary both on and of required investments in order to attract the requisite capital, be it debt or equity, to support the expenditure. If investment is undertaken without a revenue stream to support it then the regulated entity will simply run out of cash.

The Commission's proposals lack depth of analysis as they avoid making these logical linkages between growing demand for airport capacity from passengers and airlines, appropriate service levels, the infrastructure required to meet this demand and the necessity that investment be remunerated if it is to proceed. The proposals in CP4/2003 are therefore flawed as they do not take due cognisance of key issues which should be addressed if the Commission is to fulfil its statutory objective as set out in Section 33 of the Aviation Regulation Act 2001, to "*aim to facilitate the development and operation of cost effective airports which meet the requirements of users*" whilst having due regard, inter alia, to the sustainable and profitable operation of the airport.

The Commission's spreadsheet model, which underpins the level of prices proposed in CP4/2003, fails to meet its stated purpose and is deficient in a number of fundamental respects:

- It is flawed and incomplete in that it lacks the projections of cash flows which the Commission stated were required in order to choose the "correct level of prices".
- It contains a number of errors, as discussed in Section 2.2 of this document.
- It fails to accurately present a realistic financial representation of the business and includes a series of unrealistic assumptions.
- It does not address one of the key objectives set for it by the Commission, i.e. *"to check that the regulatory parameters do not threaten the financial viability of the regulated firm"*.

Any such assessment will clearly require projected profit and loss accounts, balance sheets and statement of cash flows in order to assess the resultant outcomes and financial ratios. However, the Commission's model does not include profit and loss accounts, balance sheets or cash flow statements, either calculated for the individual airports or for the company. Without these, any financial projections will be incomplete and clearly it will not be possible to properly assess the impact of the price caps proposed on the regulated entity's financial position.

It therefore appears that the Commission has not undertaken an analysis of the impact of the interim review proposals on the financial viability of the regulated entity prior to publishing CP4/2003 and its model does not appear to contain the requisite information to allow such a test to be carried out. If so, such an approach exposes Aer Rianta to an unacceptable level of financial risk and would represent a substantial deficiency in the Commission's analysis.

Aer Rianta urges the Commission to reassess its interim review proposals as a result of this submission.

STRUCTURE OF SUBMISSION

The remainder of this submission is structured as follows:

Section 1 reviews the submission made by Aer Rianta in respect of the substantial grounds which it considered there were on which to base a review of the Determination. It is surprising that the Commission has so far chosen to ignore much of Aer Rianta's application in this review process.

Section 2 provides Aer Rianta's comments on the limited range of issues, which the Commission has decided to include as part of its review. In particular, it addresses the inconsistencies in the treatment of passenger numbers and security related capex and the errors contained in the Commission's yield calculations in CP4/2003.

Section 3 provides detailed commentary on the impact of the Commission's proposals on the financial viability of the regulated entity, which the Commission appears, quite astonishingly, not to have addressed prior to the publication of CP4/2003, in contrast to the requirement under Section 33(b) that it have due regard to the sustainable and profitable operation of the airport.

1. ITEMS EXCLUDED FROM THE INTERIM REVIEW

Aer Rianta made a submission on 4th July 2003 in response to the Commission's Public Consultation Notice requesting submissions from interested parties and the public regarding a possible review of its Determination. The company identified many significant developments, which had occurred since August 2001, that provided substantial grounds for a review of the Determination. These grounds are set out below¹, together with a commentary on the Commission's treatment of each in CP4/2003.

GROUND 1

The level of capital expenditure (capex) provided for in CP7/2001 and CP2/2002 falls short of the required investment necessary to deliver IATA level of service standard B facilities and capacity for projected growth at the three Aer Rianta airports.

Not Addressed in CP4/2003

- In the original and varied Determinations CP7/2001 and CP2/2002, the Commission allowed €346 million in recoverable capital expenditure for the three airports over the 5 year regulatory period. This amounted to an allowance of circa €3 per passenger for capital expenditure. In contrast, other airports are investing an average of €6 to €10 per passenger on airport development. For example:
 - BAA, has prepared an 11-year investment programme commencing 2002 and costing £8billion² for its London airports at Heathrow, Gatwick and Stansted.
 - Aeroports de Paris (ADP) is spending US\$2.5 billion on Paris Charles de Gaulle alone in the period 1999 to 2004³,
 - Amsterdam Airport Schiphol plans to spend €2 billion in the period 2003-2008⁴.
 - Vienna Airport, which has less traffic than Dublin Airport has, plans to invest a total of US\$2.6 billion to 2015, half of this amount to be expended by 2005⁵.

¹ Given the recent Government decision, the proposed ground re regulation of the Aer Rianta airports as a group is no longer relevant.

² BAA London Airports Capital Investment Programme April 2002

³ Presentation to IATA Conference on Capacity Issues by Philip Butterworth Hayes, Managing Editor, Janes Airports Magazine, 2001

⁴ Air Transport Intelligence News, 2nd April 2003

⁵ Presentation to IATA Conference on Capacity Issues by Philip Butterworth Hayes, Managing Editor, Janes Airports Magazine, 2001

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- It is clear that, as a result of the Commission's Determination, the allowed investment levels for Irish airports are seriously out of step with investment plans for other airports across Europe and with the needs of Irish airports and their users.
- The Commission has the opportunity in the course of this interim review to address this issue⁶. It is incomprehensible that a regulatory agency that is charged with a statutory duty to ensure that the development and operation of cost effective airports that meet user requirements is facilitated, could ignore so completely the requirement for capital expenditure. This is made all the more incongruous given that the Commission has accepted the Aer Rianta traffic forecast which demonstrates the level of future demand and is a key driver of the stated capex requirements.
 - Aer Rianta believes that an effective capital planning process is in the interests both of customers and airports. In the medium to long term, lack of appropriate infrastructure and services and adequate capacity at airports will constrain growth in access into Ireland far more than any short term increases in airport charges⁷. The consequences of capacity constraints are significant including congestion, delays, lower service levels, increased costs and reduced choice. There may also be negative implications for the Irish economy, particularly in relation to trade, tourism, inward investment and employment.
 - The Commission should address each element of the detailed capex programme submitted by Aer Rianta. To the extent that the views of the airport operator on investment requirements for the airport are not taken into account, the Commission should provide details of any investments that are excluded and reasons why it believes that these investments are not required.⁸

⁶ To inform its deliberations, and in response to a request from the Commission, Aer Rianta supplied it on 27th October 2003, with a revised and detailed estimate of its capex requirements for the remainder of the current regulatory period on a project by project basis amounting to €747m for the period 2003-2006. This assessment of the investment requirements of the three principal airports in Ireland is based on a range of factors including masterplanning, passenger growth forecasts, known customer requirements and a detailed assessment of the capacity deficit for each element of airport infrastructure (baseline studies).

⁷ Indeed, the recent analysis by Doganis published January 2001, indicates that the level of airport charges has little bearing on airlines route development decisions

⁸ The Commission has expressed the view that, given that Aer Rianta is not pricing to the cap at Cork and Shannon, the issue of the levels of allowed capex in the formulation of the price cap is moot. There is a need to separate the formulation of the price cap from subsequent decisions made by the regulated entity in relation to pricing. For example, Aer Rianta intends to ultimately recoup its investment at Cork by increasing charges there as market conditions allow, though this may take a long time. In this context, it is imperative that the full cost of required investment be factored into the Commission's price cap model going forward.

GROUND 2

The exclusion from the Aer Rianta regulatory asset base of a portion of Pier C at Dublin Airport, six aircraft stands at Dublin Airport, a portion of the Shannon terminal building and the exclusion of a portion of capital expenditure for the first nine months of 2001.

Not Addressed in CP4/2003

- The Commission's decision to penalise Aer Rianta⁹ for what its consultants claimed was grounds of "excess cost" in the development of Pier C is arbitrary and unjustified, given that the cost for the project was arrived at following a competitive tendering process undertaken in accordance with EU rules in this area. The decision is contrary to the Commission's statutory responsibility under Section 5 (4) of the Aviation Regulation Act 2001 to ensure that determinations, amendments etc *"shall be objectively justified and shall be non-discriminatory, proportionate and transparent"*. The populist comments regarding "gold plating" at Dublin Airport from certain self interested parties have no substantiation either in terms of design, service levels or space at Dublin Airport.
- The Commission also disallowed 21.2% of the cost of the terminal extension project at Shannon Airport on the basis that the total terminal area provided was excessive when compared to passenger demand in the short term. However the basis for this conclusion is invalid as it assumed that the entire terminal area is available for passenger circulation, whereas the terminal extension includes a significant portion of non passenger areas e.g. plant rooms, kitchens, offices etc.
- Though Aer Rianta submitted a figure of €136m in respect of its planned capex for 2001, the Commission included recoverable capex of just €43m for the nine month period from January to September 2001. It is clear therefore, that the Commission stranded a large portion of Aer Rianta assets in the first nine months of 2001 without providing any explanation whatever. Similarly, it gave no explanation for excluding the stands at Dublin Airport. Both of these actions are contrary to the requirements of Section 5 (4) of the Aviation Regulation Act 2001.
- The unjustified stranding of assets in the regulated asset base remains a significant flaw in the Commission's approach to the original determination with adverse cashflow

⁹ By adjusting downwards the value of Pier C allowed in the RAB by 22.6%

implications for the company, and should be rectified in any new proposals that emanate from this review.

GROUND 3

The impact of the slowdown in the world economy, 9/11 and other events on Aer Rianta's traffic performance in the period since August 2001 and its financial implications for the company.

Inconsistently Addressed in CP4/2003

- The Commission's current proposals incorporate inconsistencies in the treatment of passenger numbers that unfairly discriminate against the regulated entity contrary to Section 5(4) of the Aviation Regulation Act 2001 and should be amended (details provided in section 2).
- The Commission does not appear to have addressed the impact of its proposals on the financial status of Aer Rianta. This is an approach that incorporates great risk for the regulated entity and, if so, indicates a significant deficiency in the Commission's analysis. (See Section 3)

GROUND 4

The cost implications of the enhanced security measures, insurance premiums, regulatory and restructuring costs which have arisen since CP7/2001 and CP2/2002.

Some Elements Not Addressed; Others Inconsistently and Incorrectly Addressed in CP4/2003

- The Commission's current proposals incorporate inconsistencies in the treatment of security related capex that unfairly discriminate against the regulated entity contrary to Section 5(4) of the Aviation Regulation Act 2001 and should be amended (details provided in section 2).
- The Commission has ignored the significant restructuring costs¹⁰ incurred by the company in an effort to minimise payroll cost increases in a period of enhanced security requirements and sustained passenger growth. These costs should be incorporated in the allowed operating costs. Restructuring provision has been taken account of by other

¹⁰ €28.5m provision was made by the company for the Voluntary Severance Scheme in the statutory accounts 2001.

regulators e.g. CER, and the Commission's failure to do so in this interim review represents an internal inconsistency and selectivity in its approach.

GROUND 5

The unrealistic assumptions used in projecting forward commercial revenues in CP7/2001 and CP2/2002.

Not Addressed in CP4/2003

- In its regulatory Determination, the Commission extrapolated forward Aer Rianta's commercial revenues based on unaudited General Ledger figures. It did this by taking the figure for commercial revenues for the first six months of 2001 and dividing these figures by passenger traffic for that period in order to derive per passenger values. These were then projected forward in line with inflation and forecast passenger traffic over the determination period. The extrapolation of a partial accounting period as the basis for the entire five year projection of commercial revenues is clearly an unreliable methodology.
- There is no sound or objective basis for the assumption that commercial revenues are directly correlated with passenger traffic. For example property rents and fuel sales do not grow in line with passenger growth. Actual performance to date confirms that growth in commercial revenues is less than passenger growth. (See section 3)
- Such erroneous assumptions on the part of the Commission have resulted in a situation whereby for the regulatory year 2001/2, the commercial revenues (net of cost of sales)¹¹ assumed by the Commission, were circa €30million more than those actually achieved by Aer Rianta for the same period equivalent to some €56 million on a gross commercial revenue basis¹².
- The price caps set on the basis of such an assumption, including the current proposals, are therefore fundamentally flawed, clearly not objective and give a discriminatory result. They should be addressed as part of this review.

¹¹ As calculated by Aer Rianta

¹² The Commission's original definition of gross commercial revenues comprised all commercial revenue turnover net of cost of sales of fuel (but not cost of sales of retailing and other commercial activities)

GROUND 6

The financial inaccuracies underpinning CP7/2001 and CP2/2002.

Partly Addressed in CP4/2003; Errors Remain

- The key financial errors in the Commission's original Determination that were identified by Aer Rianta in the course of the judicial review have largely been addressed insofar as they have been technically corrected, however erroneous assumptions remain (see section 3)
- However the Commission has been inconsistent in that it has made retrospective adjustments for its errors whilst only adjusting for changes in traffic from January 2004 onwards. This must be amended if the consistency of the financial model is to be maintained (Details in Section 2.1.1)
- The Commission has also made new errors in the course of the yield calculation in CP4/2003. (Details provided in Section 2).

GROUND 7

The significant computational errors and errors of principle in the IMG benchmarking analysis used to determine the efficiency factors set for Dublin and Shannon airports in CP7/2001 and CP2/2002.

Not Addressed in CP4/2003

- The Commission required in CP2/2002 that significant efficiency improvements be achieved in personnel costs at Dublin and Shannon Airports over the first three years of the Determination i.e. 18.76% and 21.66% respectively. Despite the submission of extensive analysis showing that the Commission's benchmarking study, which underpinned these efficiency targets was fundamentally flawed, and a meeting with the Commission to discuss these issues prior to the publication of CP4/2003, the Commission has not moved to review the demands placed on the company in respect of the efficiency factors that were set with reference to its flawed report. The impact of this is that opex is not reliably forecasted. The Commission's approach is contrary to its statutory responsibility under Section 5 (4) of the Aviation Regulation Act 2001 to ensure that

determinations, amendments etc *“shall be objectively justified and shall be non-discriminatory, proportionate and transparent”*.

- The Commission's actions unfairly discriminate against the regulated entity and are contrary to Section 5(4) of the Aviation Regulation Act 2001.

GROUND 8

The assumptions underpinning the subcap on off peak runway movements at Dublin Airport included in CP7/2001 and CP2/2002 and the categorisation of aircraft types for the purpose of this off peak subcap on runway movements at Dublin Airport.

Addendum to CP4/2003 Issued 27th Nov 2003

- Aer Rianta's submission in respect of the Commission's proposals regarding the treatment of the sub-cap on off peak landing and take off charges will be made in a separate paper in response to the Commission's Addendum to CP4/2003 issued on 27th November 2003.

CONCLUSION

Against the background of:

- a public notice requesting submissions
- the responding submission of detailed papers by Aer Rianta
- the provision of further detailed information by Aer Rianta in response to specific requests from the Commission (both written documentation and presentations)

it is difficult to understand why the Commission has taken such a limited approach to the interim review process and ignored crucial elements of the Aer Rianta submission in the matters which it has chosen to review. This gives cause for particular concern given the myriad deficiencies in the Determination, as highlighted by Aer Rianta's submission, and the extent to which it mitigates against the Commission fulfilling its statutory duty to *“aim to facilitate the development and operation of cost effective airports that meet the requirements of users”* by setting the maximum levels of airport charges at a level that does not allow the airport authority to make the appropriate level of investment in airport infrastructure going forward. In essence, the existing regulatory formula yields price caps that are out of line with the underlying business reality.

The Commission's decision in relation to the specific matters selected for review and/or excluded from review lacks transparency as no reasons are given for ignoring what are substantive grounds that may be, as the Commission requires

*"interpreted in a manner consistent with the Commission's statutory objective observed in the Determination i.e. the development and operation of cost effective airports that meet the requirements of users".*¹³

All of the matters raised by Aer Rianta in its submission in response to CP3/2004 could be addressed under the grounds identified by the Commission as forming the basis for its review i.e. *"commercial consequences of exogenous events"* or *"the correction of matters of computation, calculation and application arising out of information received by the Commission after the date of Determination"*¹⁴. Although the Commission has proposed that it incorporates in the review *"a correction of all matters of computation, calculation and application of which it is aware"*¹⁵ it is manifestly not following this course by ignoring information provided to it by Aer Rianta in its submission. It appears that though the Commission now has an opportunity to address the serious shortcomings in the Original Determination it has deliberately decided not to do so.

Aer Rianta is resubmitting its July submission to the Commission as part of this document, see Appendix 1, and requests that the Commission take the opportunity to address all of the substantive points made therein in the course of this review¹⁶.

¹³ CP4/2003, page 5

¹⁴ *ibid*, page 5

¹⁵ *ibid*, page 9

¹⁶ To the extent not incorporated as part of the review, Aer Rianta requires that the Commission comply with Section 32 (9) of the Aviation Regulation Act 2001 and give reasons for rejecting each representation made by Aer Rianta in the course of its report on the review of the Determination.

2. MATTERS ARISING FROM THE ITEMS ADDRESSED BY THE COMMISSION IN CP4/2003

2.1 MATTERS RELATING TO 9/11

2.1.1 INCONSISTENT TREATMENT OF PASSENGER FORECASTS IN CP4/2003

The original August 2001 and varied February 2002 Determinations were based on the Aer Rianta 2000 Traffic Forecast, however exogenous events such as September 11th (which occurred just 16 days after the Determination was issued), the slowdown in the world economy and SARS have all led to lower than anticipated growth in air traffic. While performing better than most European Airports in terms of the rate of growth since, in particular, the events of September 11th 2001, traffic at the Aer Rianta airports fell short of the Aer Rianta 2000 traffic forecast which underpinned the Regulatory Determination for the first two regulatory years.

The Commission had an opportunity, following the Aviation Appeal Panel review, to adjust the traffic figures used in the Determination to reflect the situation post September 11th. The Appeal Panel noted *"the tragic events of September 11th last may give rise to a revision of the centerline forecasts for passenger traffic by Aer Rianta which could now be taken into account by the Commission in generating revised maximum charges per passenger"*. Had the Commission taken the opportunity to revise downwards the traffic forecasts to reflect the situation post September 11th at that time the inconsistent approach it now proposes, with regard to the use of two very different sets of traffic forecasts, would not have arisen. However, the Commission chose not to do so.

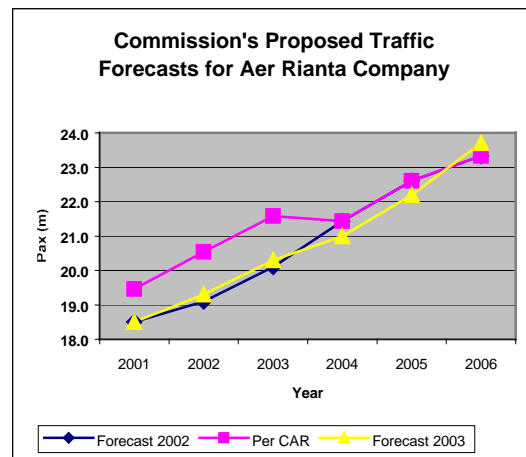
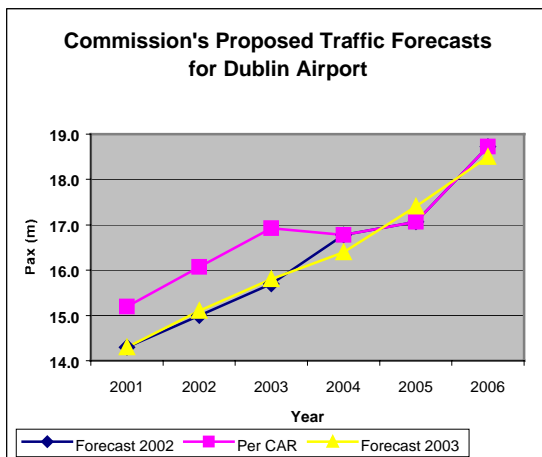
The Commission states in CP4/2003 that *"the matters subject to review here are limited to exogenous factors deemed to be outside the general business risk of Aer Rianta"*.¹⁷ It also states in relation to passenger traffic forecasts that *"the effects on traffic after 9/11 are deemed by the Commission to be an exogenous factor outside the general business risk of Aer Rianta"*.

The Commission's proposal to only apply the Aer Rianta 2002 Traffic Forecast from January 2004 onwards is inconsistent with these statements and contrasts sharply with its stated intention to retrospectively adjust all other factors being amended to the beginning of the regulatory period in

¹⁷ Section 2.1, CP4/2003

September 2001. If the effects of 9/11 on traffic are deemed by the Commission to be an exogenous factor, then the traffic benchmark should be adjusted for all years in the Determination, otherwise the Commission is not acting in an objective, proportionate and non-discriminatory fashion as required by Section 5(4) of the Aviation Regulation Act 2001. If the Commission's proposed adjustment is implemented, the Commission's regulatory determination will be based on two different traffic forecasts for the periods before and after January 2004. There is no logic or justification given for this approach, which will render the regulatory Determination inconsistent.

The graphs below illustrate the inconsistency in the Commission's approach and highlight the significant gap between the Commission's proposals and the reality of current traffic patterns. The pink line illustrates the figures, which the Commission is proposing to use in this interim review – effectively a combination of forecast 2000 figures for the regulatory period 2001-03 and forecast 2002 figures thereafter. However as can be seen from the blue line on the graph, the use of the forecast 2000 figures for the period prior to 2004 grossly overestimates the actual traffic at the airports in that period. Furthermore the yellow line illustrates the latest and most up to date traffic figures provided to the Commission by Aer Rianta in recent weeks and are the most informed basis on which to base any price cap proposals for the regulatory period.



Aer Rianta has estimated the effect of this approach on the price cap as per CP4/2003 in the table below.

	Max Yield '01/02		Max Yield 2004	
	Company	Dublin	Company	Dublin
Per CP4/2003 Max Yield (before K&W Adjustment)	€6.01	€5.09	€6.29	€5.04
K&W Adjustment			€1.27	(€0.15)
Revised Max Yield 2004			€7.56	€4.89
X Factor	5.1%	7.5%	2.9%	3.8%
Per Aer Rianta if Revised Passengers used in Prior Periods	€6.79	€5.82	€6.29	€5.04
K&W Adjustment			€2.79	€1.25
Revised Max Yield 2004			€9.08	€6.29
X Factor ¹	6.1%	8.9%	2.9%	3.8%

¹ X factor for '01/02 also incorporates security as described in Section 2.2.1 below
The traffic forecast used in the Aer Rianta calculation is forecast 2002 per Table 1 CP4/2003

Given that the Commission has accepted that the traffic out-turn has been affected by an exogenous factor and the fact that it is proposing retrospective adjustments to its Determination for the period 2001-2003 for all other elements of the yield calculation, the Commission should consistently apply the proposed adjustment for the differential between the Aer Rianta 2000 traffic forecast and the forecasts reflecting the effects of 9/11 across all years in the determination period.

2.1.2 TREATMENT OF SECURITY COSTS

The Commission has specifically invited representations from all interested parties or the public on both the level of increased security costs and what portion of such costs should be borne by airport users in light of the statutory objective of the Commission as set out in Section 33 of the Act.

Section 33 of the Act requires that the Commission in carrying out its statutory duty must have due regard to, inter alia, the operating and other costs incurred by the airport authority. There was a substantial increase in Aer Rianta's security obligations in the aftermath of September 11th. The company was obliged to implement a series of measures identified by the National Civil Aviation

Security Committee (NCASC) and with the provisions stipulated under the European Regulations 2320/2002 and 622/2003. These additional security requirements have necessitated both additional capital investment and increased operational expenditure. The level of increased security costs incurred in the period since August 2001 is related to the additional security requirements put in place.

Aer Rianta is responsible for the implementation of the various security measures dictated by the relevant regulatory and governmental bodies. Aer Rianta does not determine the level of security requirements, it would therefore be inappropriate and discriminatory if the company were to be penalised by the exclusion of a portion of its security costs from its recoverable cost base.

Aer Rianta is conscious of the need to ensure cost efficiency and it endeavours to implement its security obligations in a cost effective manner. For example, in order to deliver greater cost efficiency, it has established a specialised Airport Search Unit (ASU) to replace airport police in carrying out passenger screening and boarding card checks in the terminal area. The resulting efficiencies are incorporated into Aer Rianta's security cost projections going forward as included in Table 2 of CP4/2003.

Given the obligation on Aer Rianta to provide appropriate security at Irish airports, the impact of the Commission not allowing full recovery of security costs at the airports, would be to negatively effect Aer Rianta's ability to provide services, other than security, in a timely manner and to the appropriate level of service quality.

It is utterly inconsistent that the Commission should factor in an allowance for the operating costs associated with the new security requirements in its current proposals whilst not factoring into its calculation the capital expenditure and associated return and depreciation that is driven by the same events. The Commission has given no reason for this seemingly arbitrary decision. It states that the largest element of security related capex, hold baggage screening, has been included in the recoverable capex in the Original Determination. However, the Commission has only allowed the cost of hold baggage screening as advised in Aer Rianta's July 2001 capex submission. These figures have since been updated and whilst the costs for Shannon and Dublin are very similar to

those previously advised, the cost for HBS implementation at Cork Airport is higher. This is due to the fact that the implementation of the HBS in the new terminal at Cork is inextricably linked to the installation of the new baggage system. Contrary to the Commission's statement therefore, the ultimate impact of this is that the shortfall in the capex allowed for HBS across the three airports is €3.561m. (See table below)

CAPEX FOR HOLD BAGGAGE SCREENING			
	Aer Rianta Submission July 2001	Aer Rianta Submission	Excess/(Deficit)
	(€ 000)	Nov 2003 (€ 000)	(€ 000)
Dublin	11,427	10,085	1,342
Shannon	2,692	3,300	(608)
Cork	1,905	6,200	(4,295)
Total	16,024	19,585	(3,561)

In addition, there is a substantial sum of other capital expenditure which relates to security requirements that has not been reflected in the Commission's current proposals. This amounts to circa €15.2m and relates to capital expenditure for essential security related facilities and equipment mandated by regulations imposed on airports across Europe post the events of September 11th 2001. For example, in order to comply with the provisions set out in ECAC Doc 30, EU Regulation 2320/2002 and ICAO Annex 17, Aer Rianta will have to replace its existing access control system. The cost associated with this project alone for the three airports is estimated to amount to almost €5m. Such expenditure cannot be ignored by the Commission without justification and if it is genuine about conducting the interim review on the basis of an analysis of the commercial consequences for airport management arising from exogenous events such as September 11th 2001 then such costs must logically be included in its calculations in arriving at the new price caps.

The Commission's current price cap proposals, which do not factor in this expenditure, are inconsistent, arbitrary and put Aer Rianta at a significant disadvantage. They are therefore contrary to the Commission's statutory responsibility under Section 5 (4) of the Aviation Regulation Act 2001 to ensure that determinations, amendments etc *"shall be objectively justified and shall be non-discriminatory, proportionate and transparent"*.

2.2 MATTERS OF COMPUTATION

One of the key drivers of this interim review is to enable the Commission to address the very many errors, which were incorporated in the Original Determination. The Commission has sought in the past to attribute these errors to the fact that it was required to make its initial Determination within a very short period of time (6 months).

In the intervening period since the publication of the Original Determination in August 2001, Aer Rianta has

- exchanged detailed correspondence with the Commission via the Judicial Review process in relation to the genesis of the errors made
- at the Commission's request it has reviewed rudimentary elements of the Commission's 2003 models, such as depreciation and calculation of the RAB, and
- made detailed and specific recommendations in respect of any inaccuracies detected

Against this background the Commission would appear to have corrected the principal errors in its original Determination. However, the Commission's interim review proposals, drafted two years after the original Determination was issued, incorporate a number of **new** errors. These are set out below:

2.2.1 SECURITY ADJUSTMENT IN PRIOR PERIOD

The Commission has carried out a manual per passenger adjustment to reflect increased security costs. However this methodology results in an incorrect X factor being used as the security adjustment was effectively done outside the model. The correct methodology is to include the security adjustment as additional opex, resulting in an opening maximum yield and an X factor that incorporates the effect of the security adjustment in the future years. The effect of this error is that the minus X factor is increased and Aer Rianta's maximum yield is less than what it would be if this error did not exist, see table below:

	Max Yield '01/02		Max Yield 2004	
	Company	Dublin	Company	Dublin
Per CP4/2003 Max Yield (before K&W Adjustment)	€6.01	€5.09	€6.29	€5.04
K&W Adjustment			€1.27	(€0.15)
Revised Max Yield 2004			€7.56	€4.89
X Factor ¹	5.1%	7.5%	2.9%	3.8%
Per Aer Rianta if security adjusted via X Factor in prior periods	€6.01	€5.09	€6.29	€5.04
K&W Adjustment			€1.32	(€0.11)
Revised Max Yield 2004			€7.61	€4.93
X Factor	4.0%	6.6%	2.9%	3.8%

¹ In Table 5 CP4/2003 X factor for '01/02 does not incorporate security adjustment. The adjustment was a manual adjustment to the max yield on an annual basis in 02/03 and 03/04, which is not consistent with the CPI-X formula, the chosen method of price cap calculation by the Commission. The traffic forecast used is that proposed per the Commission in Table 1 CP4/2003

IN THE MODEL PERTAINING TO FUTURE PERIODS, THE SECURITY ADJUSTMENT IS INCLUDED IN OPEX AND THEREFORE REFLECTED IN THE X FACTOR. THUS THE APPROACH IN PRIOR PERIODS AND FUTURE PERIODS IS INCONSISTENT.

2.2.2 THE COMMISSION'S PROJECTION OF INCREMENTAL SECURITY OPERATING COSTS

In order to ascertain the incremental security operating expenditure to be allowed, the Commission compared the security operating expenditure as allowed in the Revised Determination with Aer Rianta's current estimate of security operating expenditure.

In order to ascertain what was allowed in the Revised Determination, the Commission took the actual security operating expenditure for 2001 and extrapolated forward based on the Commission's original methodology (traffic growth plus inflation). The Commission then compared these extrapolated figures with the actual and projected security figures as provided by Aer Rianta and the difference between the two figures was deemed to be the incremental security costs. However, in calculating the security costs included in the Revised Determination, the Commission failed to recognise that the figures as extrapolated should have been reduced by the efficiency

factor that the Commission had applied to personnel costs in the Revised Determination. Thus the security adjustment incorporated in the calculation of the price caps proposed in CP4/2003 is understated. It is the extrapolated security payroll costs less the efficiency factor that should have been compared to the actual and projected security payroll costs supplied by Aer Rianta, which reflect the efficiencies resulting from Aer Rianta establishing the ASU, to ascertain the incremental security operating expenditure figure. The effect of this error is as follows:

	Max Yield '01/02		Max Yield 2004	
	Company	Dublin	Company	Dublin
Per CP4/2003 Max Yield (before K&W Adjustment)	€6.01	€5.09	€6.29	€5.04
K&W Adjustment			€1.27	(€0.15)
Revised Max Yield 2004			€7.56	€4.89
X Factor	5.1%	7.5%	2.9%	3.8%
Per Aer Rianta if extrapolated security adjusted for efficiency	€6.06	€5.14	€6.44	€5.19
K&W Adjustment			€1.48	€0.05
Revised Max Yield 2004			€7.92	€5.24
X Factor ¹	3.0%	5.3%	2.8%	3.7%

¹ X factor for '01/02 also incorporates security as described in Section 2.2.1 above
The traffic forecast used is that proposed per the Commission in Table 1 CP4/2003

2.2.3 INCORRECT CALCULATION OF TAXATION CHARGE

In the current model, the Commission calculated the tax charge by multiplying the effective tax rate by the return (as adjusted for capital allowances and depreciation). However as the return is actually the profit after tax and before interest, the tax charge should be calculated by grossing up the return to the pre tax level and applying the tax rate to this gross amount (as adjusted for depreciation and capital allowances). The Commission grossed up the return in the Revised Determination but did not do so in the current model. As a result the tax charge as shown in the current model is now understated. The effect of this is shown below:

	Max Yield '01/02		Max Yield 2004	
	Company	Dublin	Company	Dublin
Per CP4/2003 Max Yield (before K&W Adjustment)	€6.01	€5.09	€6.29	€5.04
K&W Adjustment			€1.27	(€0.15)
Revised Max Yield 2004			€7.56	€4.89
X Factor	5.1%	7.5%	2.9%	3.8%
Per Aer Rianta if calculation of tax corrected	€6.06	€5.14	€6.36	€5.10
K&W Adjustment			€1.43	€0.00
Revised Max Yield 2004			€7.79	€5.10
X Factor ¹	3.9%	6.3%	2.9%	3.8%

¹ X factor for '01/02 also incorporates security as described in Section 2.2.1 above
The traffic forecast used is that proposed per the Commission in Table 1 CP4/2003

3. FINANCIAL ASPECTS OF CP4/2003

The Commission bases its determinations of airport charges on a spreadsheet model incorporating assumptions selected by the Commission regarding future passenger volumes, revenues and operating costs. The Commission has stated that its financial model is *“the embodiment of all policy decisions of (the Commission’s) Determination (of Airport Charges)”*.¹⁸ The Commission has also stated that

*“Choosing the correct level of prices for a regulated firm requires projections of the prospective cash flows resulting from alternative price structures. A critical factor in the choice will be whether the resulting cash flows are excessive on the one hand or inadequate on the other”*¹⁹.

Following the publication of CP4/2003, the Commission provided Aer Rianta with its November 2003 Review Financial Model that underpins the airport charges proposals contained in that document. In the Commission’s Explanatory Note and Assumptions Book that accompanies its spreadsheet model the purpose of the model is stated as being four fold:

- *“To set the correct level of prices for the start of the regulatory period;*
- *To determine the correct level of X;*
- *To determine and analyse the relative effects of alternative policy directions;*
- *To check that the regulatory parameters do not threaten the financial viability of the regulated firm.”*²⁰

The Commission’s spreadsheet model, which underpins the level of prices proposed in CP4/2003, fails to meet its stated purpose and is deficient in a number of fundamental respects:

- It is flawed and incomplete in that it lacks the projections of cash flows, which the Commission stated were required in order to chose the *“correct level of prices”*.
- It contains a number of errors, as discussed in Section 2.2 of this document.

¹⁸ Statement by the Commission’s Head of Economic Affairs, Paragraph 13 of his first affidavit, from Judicial Review proceedings.

¹⁹ Statement by the Commission’s Head of Economic Affairs, Paragraph 9, 1st Affidavit, Judicial Review Proceedings

²⁰ Commission for Aviation Regulation, November 2003 Review Financial Model Explanatory Note and Assumptions Book, pg 1

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- It fails to accurately present a realistic financial representation of the business and includes a series of unrealistic assumptions. These have been well documented to the Commission as part of the Judicial Review process.
 - It does not address one of the key objectives set for it by the Commission, i.e. *“to check that the regulatory parameters do not threaten the financial viability of the regulated firm”*.

INACCURATE REPRESENTATION OF THE BUSINESS

The Commission’s spreadsheet model fails to accurately present a realistic financial representation of the business. This is particularly apparent in relation to its projections of commercial revenues and operating costs where there is a complete absence of commercial reality, the combined impact of which results in forecast levels of profitability that are grossly overstated when compared to the actual level of profitability being experienced by the business. In this context, current actual levels of EBITDA²¹ - an established profit measure - would need to increase by some 65-70% in order to reach the forecasts assumed by the Commission.

This is clearly illustrated by comparing actual commercial revenues and level of opex cost achieved over the first three “forecast” years of the regulatory quinquennium (plus the levels anticipated for financial year 2004) with those assumed by the Commission (even after revising its assumptions under CP4/2003). This comparison is illustrated in the graphs in Confidential Appendix 2, where the Commission projections for key measures - EBITDA, commercial revenues and payroll and related costs - are shown in blue and actual levels/Aer Rianta’s figures shown in red. **Please note that figures for 2003 and 2004 should not be published or released without the prior agreement with the company as they contain price sensitive data.** These figures for the company are a reflection of the basic financial forecasting assumptions made by the Commission and level of return on capital allowed. Effectively they exclude the impact of other factors such as the level of capital expenditure and depreciation and tax calculations.

²¹ Earnings before interest, tax, depreciation and amortisation

Commercial Revenues

The Commission's projections of commercial revenues are very important, as a presumption of strong increases in such revenues over the regulatory period has the effect of reducing the level of airport charges that could otherwise result from the regulatory formula.

The Commission has projected that commercial revenues at the three airports will consistently grow in line with passenger growth plus inflation. However, this is not a soundly based assumption, as experience clearly shows. Reasons for this have already been well documented to the Commission and include for example:

- Several streams of revenue are not directly connected to passenger growth, for example, rental income.
- Revenues from other commercial activities that are assumed to have a correlation to passengers do not necessarily increase at the same rate as passenger growth. For example, not all additional passengers result in additional car parking revenue, as several modes of transport to and from the airports are available to passengers, some of which do not accrue revenue to Aer Rianta. Car parking revenue is also dependent on the availability of car parking infrastructure, therefore, as capacity is reached, substantial incremental capital investment is required to ensure continued growth in revenues.

Overall, not only has the Commission made the unrealistic assumption that all commercial revenues will grow in line with both passenger growth and inflation, but the Commission's allowed capital expenditure does not allow for sufficient investment in commercial infrastructure to enable Aer Rianta achieve the commercial revenue projections included by the Commission in its calculation of price caps. The Commission's unrealistic assumptions have resulted in a situation, where for the year 2003 the commercial revenues assumed in CP4/2003, are **€ million (Note: This figure was supplied to the Commission as confidential)** more than those expected to be achieved by Aer Rianta for the same period.

Operating Costs

The Commission has assumed that payroll and other personnel related operating costs will have declined in real terms by a substantial "efficiency factor" amounting to 18.75% and 21.67% at

Dublin and Shannon Airports respectively, by September 2004. (Extensive analysis has proved that the Commission's benchmarking study, which underpinned these efficiency targets was fundamentally flawed, as referred to earlier). The total quantum of such savings over the five year regulatory quinquennium amounts to €103 million, resulting in correspondingly lower airport charges over that period. Quite apart from the unjustified savings assumed, the Commission's assumptions also ignore the impact of national pay award increases (which Aer Rianta is committed to), and pay increments (which are a normal feature of many comparable remuneration structures).

In addition, the general assumption that other non payroll costs will grow in line with passenger growth and inflation ignores the fact that increases in infrastructure capacity have a significant impact on incremental cost growth for certain categories of cost e.g. energy, cleaning, rates, insurance etc.

The reliability of the Commission's operating cost projections are also damaged by the fact that the Commission extrapolated a partial accounting period as the basis for the entire five year opex projections, rather than taking a full financial year.

FINANCIAL VIABILITY TEST

Section 33(b) of the Aviation Regulation Act 2001 requires that the Commission shall, in making a determination, have due regard to the sustainable and profitable operation of the airports. Clearly, the Commission's self imposed, and essential, requirement to test that the prospective cash flows resulting from alternative price structures are adequate, is key to an assessment of such sustainability and profitability. Indeed, one of the four stated purposes of the Commission's model is to check that the regulatory parameters do not threaten the financial viability of the regulated firm.

Any such assessment will clearly require projected profit and loss accounts, balance sheets and statement of cash flows in order to assess the resultant outcomes and financial ratios. However, the Commission's model does not include profit and loss accounts, balance sheets or cash flow statements, either calculated for the individual airports or for the company. Without these, any

financial projections will be incomplete and clearly it will not be possible to properly assess the impact of the price caps proposed on the regulated entity's financial position.

The purpose of the financial viability test (or bankability) is to ensure that key financial ratios for the regulated company over the control period are consistent with the credit rating assumed by the regulator, in setting the company's cost of debt, capital structure, and overall WACC²². If the financial ratios are not consistent with the assumed credit rating, then the company will face a higher cost of capital than was factored into the calculation of the allowed revenue, which will in turn threaten the viability of the company²³. In testing for the financial viability of the proposals the model needs to:

- Determine the key ratios that are important in analysing a company's credit rating and assessing financial strength;
- Measure these against minimum threshold values for these key ratios;
- Test the financial projections and the resulting financial ratios and outcomes under downside as well as central scenarios to ensure that the regulated company can finance activities under more difficult economic circumstances than the central case assumes.
- Ensure that these are commercially realistic and achievable

Aer Rianta contacted the Commission's Head of Economic Affairs on 18th November 2003 to ascertain whether the Commission had undertaken such assessments in advance of the publication of CP4/2003, either as part of the financial model or elsewhere. Aer Rianta was informed that though there had been an extensive "financial leg" to the original model the model

²² Weighted average cost of capital

²³ In its Determination, the Commission and its expert advisors had regard, inter alia, to Aer Rianta's credit rating, the yield on Aer Rianta's traded Eurobond and in particular the risk premium on that bond. This risk premium will be influenced, inter alia, by the assessment of Aer Rianta's credit rating at any point in time. Aer Rianta's current credit rating is 'A' with negative outlook. This is significantly lower than the 'A+' rating with positive outlook, which pertained immediately following the Commission's draft Determination in 2001. The current rating and in particular negative outlook reflects the expectation of Standard & Poor's that Aer Rianta will continue to have a weak financial profile. There is also uncertainty regarding any improvement (in the interim review) in the company's airport charge regime to support an adequate financial profile for an A rating. Standard & Poor's has commented that "*the implementation of charges in accordance with the Regulatory Determination has eroded Aer Rianta's financial profile*".

had been “cut back drastically” this time out and that “the full blown analysis was not in the model this time”. This must explain what is meant by the Commission in the introduction to its Explanatory Note and Assumptions Book, that accompanies the Model viz:

*“The Commission 2003 Revised Financial Model (the “Model”) described herein was developed to support the Commission for Aviation Regulation (the “Commission”) in its consideration of a review of the price caps published by the Commission in its Revised Determination (the “Revised Determination”) of February 2002. It builds upon the financial model used to calculate those price caps **by removing extraneous elements of that model** as well as incorporating revised assumptions and methods and correcting errors that have come to light in the period since the publication of that Revised Determination.” (emphasis added)*

It therefore appears that the Commission has not undertaken an analysis of the impact of the interim review proposals on the financial viability of the regulated entity prior to publishing CP4/2003 and its model does not appear to contain the requisite information to allow such a test to be carried out. If so, such an approach exposes Aer Rianta to an unacceptable level of financial risk and would represent a substantial deficiency in the Commission’s analysis which must be addressed prior to the finalisation of the new price caps.

APPENDIX 1 AER RIANTA SUBMISSION 4TH JULY 2003

APPENDIX 2 COMPARISON OF KEY FINANCIAL MEASURES - CONFIDENTIAL