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DAA Response to CP4/2008

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Efficiency Incentives (Rolling Incentive Schemes)

Executive Summary

DAA welcomes the Commission's publication of its discussion paper examining the efficiency incentives prevailing under the current price cap regime and the possibility of increased incentivisation through the introduction of a rolling incentive scheme.

DAA agrees with the Commission that there is merit in examining whether there are possible remedies to the current distortions to efficiency implicit in the current price cap structure.

However DAA would like to emphasise that it is the company's policy to seek to maximise operating and capital expenditure efficiencies where possible and to date it believes that this policy has not been compromised by the timing of the regulatory determination period. It is also worth noting that DAA engages in a number of commercial activities which operate within competitive markets where market forces create incentives for ongoing efficiencies.

DAA agrees with the Commission that from a theoretical perspective under the current price cap regime, there are stronger incentives to outperform a particular operating/capital expenditure target at the beginning rather than the end of a regulatory period as the timing of a particular efficiency measure is highly significant in determining the level of cost savings which will accrue to the regulatory firm. This is due to the fact that a cost saving measure introduced in year one of a five year regulatory period will yield maximum benefit for the full five year period while a similar measure introduced in the fifth year will only provide minimum benefit to the firm for that final year. DAA therefore recognises that in principle this could create a potential distortion to efficiency within the price cap regulation model. It accepts that theoretically this perverse regulatory signal could impact efficiency in regard to commercial revenues and operating /capital expenditure.

DAA accepts in principle that the introduction of a rolling incentive mechanism could possibly strengthen efficiency incentives for a regulatory firm. A rolling incentive scheme could allow for the benefits of a particular cost saving to be accrued evenly for a set period such as five years regardless of the timing of the measure within the regulatory determination period. Therefore DAA accepts in theory that a rolling incentive mechanism could incentivise a regulated firm to realise cost savings whenever possible by eliminating any distortion arising from the timing of such a measure.

While DAA acknowledges that the concept of a rolling incentive mechanism has merit as a theoretical proposition and can technically be applied to over/underperformance in relation to operating expenditure, capital expenditure and commercial revenues, it believes that this is a concept that has yet to be validated in a practical airport context.

There is currently no regulatory precedent within the airport sector for the introduction of a rolling incentive mechanism.

The introduction of a rolling incentive scheme may have the positive effect of removing any possible bias on the part of a regulated firm in regard to the timing of efficiency improvements but the scheme itself could have a potential negative impact in terms of high associated administration costs, reduced flexibility or higher regulatory risk. Therefore the Commission must assess the potential benefits against the possible negative effects of such a scheme and it must be able to demonstrate that the marginal benefits of a particular rolling incentive scheme will exceed the associated marginal costs in order for such a proposition to be considered viable in practice.

DAA does not believe that a rolling incentive mechanism in relation to capital expenditure is warranted at this juncture.

DAA would like to propose to the Commission that over the course of the forthcoming regulatory determination period the company would continue to strive to identify further measures to deliver additional efficiency benefits and where a potential opportunity is identified in relation to either operating expenditure or commercial revenues meeting a set criteria, this could be discussed with the Commission in detail and it could then consider the application of a rolling incentive mechanism to either operating expenditure or commercial revenues in this context.

Regulatory Precedent

There is currently no regulatory precedent within the airport sector for the introduction of a rolling incentive mechanism. During its fifth regulatory review, the UK airport regulator proposed the introduction of an operating expenditure incentive mechanism to make efficiency incentives more consistent over the five-year regulatory period. Given that the regulated company would be seen as a beneficiary of a successfully structured rolling incentive scheme this is noteworthy.

In the ensuing debate, BAA concluded that while it recognised the potential from a rolling incentive mechanism for incentives relating to operating expenditure efficiency, it remained to be convinced that these benefits would be sufficient to offset the increased administrative burden associated with such a scheme.

The CAA outlined how certain characteristics of the airport structure meant that an operating incentive mechanism was not necessarily appropriate for that regulated sector. It suggested that airports tended to have revenue and cost streams which were outside the regulatory sphere, it noted that operating expenditure was not necessarily as significant a factor in the airport sector as it was in other sectors and that there was a danger that to introduce a rolling incentive mechanism under the single till regime could create additional distortions in the market. However, ultimately the CAA decided that there was insufficient case for the introduction of a rolling incentive mechanism at that time.

DAA Response to Stated Principles

The Commission has asked us to comment on the merits/ benefits of the possible introduction of a rolling incentive mechanism in relation to the following stated principles.

Consumer Benefit
We have been asked to comment on whether the introduction of a rolling incentive mechanism will enhance user welfare. In order for user welfare to be enhanced it must be clear that the introduction of a rolling incentive would result in strong enhanced efficiency incentives in the regulated sector leading to a gain in overall economic efficiency.

However it is not apparent that a theoretical proposition such as rolling incentive mechanism would result in efficiency enhancement in practice. The perceived benefits from the application of a rolling incentive scheme may not outweigh the potential costs attributable to the introduction of such a scheme.

The introduction of a rolling incentive scheme may have the positive effect of removing any possible bias on the part of a regulated firm in regard to the timing of efficiency improvements but the scheme itself would have a potential negative impact in terms of high associated administration costs, reduced flexibility or higher regulatory risk. Where the potential negative effects outweigh any possible benefits the rolling incentive scheme could of itself distort the regulatory market and reduce economic efficiency.

Therefore in order for user welfare to be enhanced the marginal benefits of a particular rolling incentive scheme must exceed the marginal costs associated with the introduction of such a scheme.

Therefore if the Commission is to conclude that a particular incentive mechanism adds to user welfare, it must be able to assess the impact of such a measure in practice.

Consistency of incentives through time
The Commission has concluded that the incentives offered to the firm must not vary within each year of a regulated period or even across different regulatory periods.

From a theoretical perspective, the consistent application of a clear defined rolling incentive mechanism should result in the consistency of incentives through time. In principle such a scheme should remove any existing distortion in the regulated market with regard to the timing of the introduction of a possible cost saving.

However in practice there could undoubtedly be increased regulatory risk and reduced incentives at the start of a regulated period where there is uncertainty as to how the design of a particular rolling incentive scheme will be applied just as regulatory risk is likely to increase towards the end of a regulatory period with added uncertainty as to how a rolling incentive scheme will apply going into the following regulatory determination period. There is therefore the potential that the application of a rolling incentive scheme could still result in varying degree of incentives offered to the regulated firm over time.

Consistency of incentives across building blocks
The Commission has suggested that there should be a consistency of incentives between operating and capital activities. Under a rolling incentive mechanism, in principle a firm can be incentivised to seek both operating expenditure efficiencies and capital efficiencies simultaneously.

However it is important to distinguish between real cost savings in relation to capital expenditure as opposed to undercapitalisation. Where a firm takes a decision to undercapitalise in order to reap a perceived capital efficiency benefit there has the potential to lead to higher operating expenditure where the firm is attempting to maintain service standards. Similarly, there is a potential discontinuity between operating and capital expenditure incentives where a firm decides to undertakes efficient capital expenditure in order to introduce new capacity in a timely and appropriate manner knowing this will lead to an associated step increase in operating expenditure.

In this context, it is also important to ensure that any incentive scheme does not lead to sub-optimal decisions regarding investment in commercial opportunities, particularly where there might be a time delay between the actual investment, both capital and operating costs and the subsequent commercial revenues. Any incentive scheme applied to operating costs and capital expenditure should not penalise for the firm for underperformance arising from investing in a particular commercial opportunity, particularly where such an opportunity delivers a return higher than the cost of capital, thereby benefiting users in the longer term with reduced airport charges.

Quality of Service
The Commission has stated that any additional incentives must not distort the existing price /quality incentives faced by the airport. However, there is a danger that the introduction of a rolling incentive scheme that results in strong incentives to reduce operating expenditure or to under capitalise could have a potential negative impact on service quality.

Where a firm is seeking continuous measures to reduce operating costs or is striving to limit its capital expenditure requirements, over time in order to continue to reap additional cost savings a result could be a compromise on the standard of service offered and the quality of facilities on offer.

Transparency
The Commission is suggesting that the firm and its users must know in advance how the scheme would apply so that the firm can forecast with

certainty the benefits of outperformance and users can identify the long run benefits accruing to them. This level of transparency will require a significant degree of commitment from all parties involved.

It will be necessary for the Commission to publish detailed materials outlining the design and application of the rolling incentive mechanism. This will require extensive and continuous interaction between the Commission and the regulated firm. It may mean that extensive and detailed information in relation to the regulated firm's costs would have to be made available to all airport users. It would require specialised skills on the part of the regulated firm and airport users in analysing the cost implications and application of the scheme in order to forecast any perceived benefits in advance. Overall it may require an extensive time commitment from the Commission, the regulated entity and interested airline users.

Simple to apply

The Commission has stated that any proposed scheme must not be overly burdensome on the firm, its users or the Commission and must not require significant departures from the well-known concepts of regulatory building blocks and the price cap formula.

It is acknowledged that rolling incentive schemes are extremely complex to apply in practice. The application of such a scheme will require a considerable increase in regulatory intervention. It will add considerably to the regulatory burden faced by the regulated firm. It will require an extensive time and resource commitment from all parties involved.

The design and application of such a rolling incentive scheme will inevitably involve a great deal of initial planning in order for to achieve its successful introduction. It will then require extensive ongoing maintenance and updating throughout the regulatory period. It will require extensive continuous interaction between the Commission and the regulated firm in order to ensure its valid operation. Undoubtedly such scheme will add considerably to the complexity of the current regulatory system.

The Application of Rolling Incentive Mechanism to Regulatory Building Blocks

DAA would like to discuss the application of a rolling incentive scheme in relation to three specific building blocks; operating expenditure, commercial revenues and capital expenditure.

Operating Expenditure

DAA accepts that from a theoretical perspective the introduction of a rolling incentive mechanism would increase incentives for the regulated firm to achieve operating efficiency where an opportunity arises. The introduction of such a scheme would allow for the benefits of a particular cost saving to be accrued evenly for a set period such as five years regardless of the timing of the measure within the regulatory determination period.

DAA agrees that in principle a rolling incentive scheme applied to operating expenditure could benefit both the regulated firm and add to overall economic efficiency. However, the company would have concerns about the practical application of such a scheme.

The application of a rolling incentive scheme would add considerably to the complexity of the regulatory model, it would increase both the regulatory risk and the regulatory burden imposed on the regulated firm and it would require a higher degree of regulatory intervention on the part of the Commission.

In order for such a scheme to prove beneficial it would require an extremely accurate assessment of the company's forecast operating expenditure including a realistic projection of likely future efficiencies. The regulated firm will only have an incentive to achieve greater cost efficiencies where the relevant expenditure forecasts are recognised as acceptable by the company. This would therefore require a commitment on behalf of the Commission to enter into detailed discussion with DAA during each regulatory review in order to agree a mutually acceptable operating expenditure forecast upon which a rolling incentive mechanism could apply during the next regulatory determination period. There would also be a requirement for ongoing monitoring on the part of both the Commission and the DAA throughout the regulatory period to ensure that the mechanism was applied accurately.

DAA is of the view that a potential rolling incentive mechanism should be applied exclusively to operating expenditure overperformance. It does not believe that potential efficiency benefits can be derived from applying such a scheme to operating expenditure underperformance. DAA is extremely concerned that if the Commission chose to apply a rolling incentive scheme to underperformance this could possibly add distortions to the existing price cap structure. This would be a particular high risk where the Commission underestimated operating expenditure (or overestimated likely efficiencies) leading to a lower airport charges price cap as a result of the application of the rolling incentive scheme to the company's underperformance. This lower price cap could potentially distort the current price cap structure by weakening allocative efficiency thereby reducing overall economic efficiency within the regulated market.

From the company's perspective, DAA is concerned that the potential application of a rolling incentive mechanism to underperformance in relation to operating expenditure forecasts could add considerably to the company's regulatory risk and adversely affect the company's future financeability.

DAA believes that any potential application of an operating expenditure rolling incentive scheme should only be applied to operating costs within the company's control. In 2006, non-payroll costs accounted for 40% of the company's operating costs and 40% of non-payroll costs (energy costs, insurance, rates and regulatory levy) were externally determined and therefore non–controllable. The company is of the view that it would be inappropriate for the regulated firm to either benefit from or be penalised for over/under performance in relation to costs beyond its direct control e.g. an increase in energy costs. There is a concern that the application of a rolling incentive scheme to non- controllable operating expenditure would both increase the regulatory burden for the airport operator and the potential level of distortion in the regulated market.

In regard to passenger numbers and the potential introduction of a rolling incentive scheme, it should be noted that unanticipated increases in passenger numbers will potentially increase DAA's operating expenditure (particularly where the airport has strong incentives to maintain service quality standards) however unexpected falling passenger numbers will not automatically reduce operating costs given the fixed nature of the various costs in the short run. It would therefore be inappropriate for the Commission to treat additional operating costs associated with higher passenger numbers as a measure of underperformance for the purpose of a potential rolling incentive mechanism.

However despite the concerns addressed above, on balance DAA accepts that the application of a rolling incentive mechanism to operating expenditure at Dublin Airport may in certain circumstances yield potential efficiency benefits for DAA and its airports users. Therefore, the company suggests that the Commission consider the possible introduction of such an incentive scheme to apply to specific operating expenditure initiatives (e.g. a restructuring of an element of the cost base) identified as meeting the following criteria; a discrete self-contained project, of significant potential value, with an identifiable timeline and a clearly defined set of objectives.

It therefore proposes to the Commission that over the course of the forthcoming regulatory determination period where a potential operating expenditure initiative is identified this could be discussed with the Commission in detail and the application of a rolling incentive mechanism could be considered in this context.

Capital Expenditure
DAA questions whether or not there is any potential economic benefit to be derived from the application of a rolling incentive mechanism to the company's capital expenditure.

The application of a rolling incentive scheme will increase the complexity of the current regulatory regime, it will potentially add to both the regulatory risk and the regulatory burden experienced by the regulated firm and it will require additional regulatory intervention from the Commission.

In order for a rolling incentive scheme to be applied to capital expenditure a definitive recoverable capital expenditure programme would have to be agreed between the Commission and DAA for each regulatory determination period. This would therefore require a commitment on behalf of the Commission to enter into detailed discussion with DAA during each regulatory review in order to set clear parameters for the recoverable capital programme. There would also be a requirement for ongoing monitoring on the part of both the Commission and the DAA throughout the regulatory period to ensure that the mechanism was applied accurately in relation to evolving capital expenditure.

DAA is concerned in particular as to how capital expenditure underperformance/ overperformance will be defined in designing a potential rolling incentive scheme. The Commission would have to set definitive guidelines as to what it believes would constitute capital expenditure over/under performance under such a proposal.

It would be a matter for considerable debate as to whether overperformance would be defined as where individual capital expenditure projects are delivered under budget or where the overall quantum of capital expenditure is lower than that anticipated in the regulatory capital expenditure projections.

DAA would need clarity in relation to the potential treatment under the rolling incentive mechanism of additional unanticipated capital expenditure that the airport would be required to undertake for the purposes of safety/security or meeting airport user requirements, or as a result of the emergence of a commercial opportunity that would have the overall impact of reducing airport charges where the return from such an opportunity is greater than the cost of capital.

DAA believes that under such a rolling incentive scheme, the company should not be penalised for underperformance where capital costs are higher than anticipated due to factors outside of the company's control (e.g. rising construction inflation, planning timelines and conditions imposed in planning permissions and unanticipated construction delays).

DAA is concerned that under such a scheme there is potential for capital investment deemed a requirement by the airport operator and /or airport users to be excluded from the RAB as it was unanticipated in the regulatory capital expenditure forecasts. This would distort the current price cap structure by weakening allocative efficiency thereby reducing overall economic efficiency within the regulated market. This would also add considerable to the company's regulatory risk as DAA would be left with potential stranded assets which would not yield a financial return.

From the company's perspective, DAA is concerned that the potential application of a rolling incentive mechanism to underperformance in relation to capital expenditure forecasts could potentially increase the company's regulatory risk and weaken the company's future financeability.

In principle, DAA questions the need for such a considerable ex ante examination of capital expenditure given the stringent controls currently imposed on capital expenditure under the current regulatory regime[1]and also the potential for conflicting reactions to the capital investment incentives. The addition of a rolling incentive scheme could add further to the regulatory uncertainty experienced by DAA and the level of regulatory intervention required on the part of the Commission.

Commercial Revenues

DAA accepts that in theory the introduction of a rolling incentive mechanism could create additional incentives for the regulated firm to seek additional increases in commercial revenues over the course of a regulatory revenue period. The introduction of such a scheme would allow for the benefits of a particular revenue increase to be secured evenly for a set period such as five years regardless of the timing of the unanticipated revenue gain within the regulatory determination period.

Nevertheless, DAA believes that since in practice the bulk of the company's commercial revenue activities operate within a competitive market framework it may add to the complexities of these markets by imposing a rolling incentive mechanism on DAA's commercial activities.

However, the Commission has suggested that it may look in this context at commercial revenues where DAA faces weaker competitive constraints. The company would have serious concerns about the application of such a scheme in practice. It does not believe it would be appropriate for the Commission to introduce a scheme that would incentivise overperformance in areas where DAA may have a certain degree of market power.

If the Commission chose to go ahead with such a scheme, it would require a very high level of confidence as to the accuracy of the underlying forecasts set by the Commission and detailed interaction between the Commission and DAA. DAA does not believe that any potential efficiency benefits can be derived from applying such a scheme to commercial revenue underperformance. DAA is extremely concerned that if the Commission chose to apply a rolling incentive scheme to underperformance this could possibly add additional distortions to the existing price cap structure. There could

[1] The Commission has to date employed a number of different measures with the stated objective of incentivising capital expenditure e.g. its methodology in relation to the roll forward of the RAB, trigger pricing, the stranding of certain assets and the clawback of returns on the RAB.

potentially be a high risk where the Commission overestimates DAA's potential for future commercial revenues and then applies a rolling incentive scheme to what is deemed to be the company's commercial revenue underperformance. The resulting lower airport charges price cap could potentially distort the current price cap structure by weakening allocative efficiency thereby reducing overall economic efficiency within the regulated market, as it did in the 2001-05 period.

DAA is concerned that the potential application of a rolling incentive mechanism to underperformance in relation to commercial revenue forecasts could again add considerably to the company's regulatory risk and adversely affect the company's future financeability.

DAA however accepts that for certain commercial initiatives the potential introduction of a rolling incentive scheme may prove beneficial. DAA would like to propose that the Commission consider a possibility limited application of the rolling incentive mechanism to commercial revenues where a particular specifically identifiable commercial initiative with clearly defined potential benefits is deemed to warrant the application of such a scheme.

The Application of a Rolling Incentive Mechanism in Practice

As DAA acknowledges earlier, the company accepts that the concept of a rolling incentive mechanism has strong merit as a theoretical proposition and can technically be applied to over/underperformance in relation to operating/capital expenditure and commercial revenues. However, it believes that this concept has yet to be proven in practice and particularly within an airport context.

DAA believes that in order for a possible application of a rolling incentive mechanism within the Dublin Airport context, there needs to be a higher degree of consistency going forward between the Commission future projections and DAA's forecasts in relation to the relevant building blocks. Given that underperformance and overperformance under the rolling incentive mechanism will be assessed in relation to the Commission's regulatory assumptions, the regulated firm will only have an incentive to achieve greater cost efficiencies where the relevant cost/revenue projections are recognised as acceptable by the company.

There is the very real danger that where the Commission sets its cost/revenue assumptions at unrealistic levels the application of a rolling incentive scheme could add considerably to potential distortions in the market as it will amplify the impact of inaccurate projections and inappropriate regulatory decisions. From the company perspective, there is the concern that this could potentially add considerably to the company's regulatory risk and adversely affect the company's future financeability.

It should be noted that the introduction of a rolling incentive mechanism would add significantly to the complexity of regulation. There would be a requirement for a number of detailed parameters to be agreed between the airport operator and the regulator. The design and application of such a rolling incentive scheme will inevitably involve a great deal of initial planning in order for its successful introduction. It would then require detailed ongoing maintenance and updating throughout the regulatory period. It would require extensive continuous interaction between the Commission and the regulated firm in order to ensure its valid operation. It would therefore clearly involve a high degree of regulatory involvement on the part of the Commission and it is apparent that the introduction of such a measure will not facilitate the Commission's statutory requirement to impose minimise restrictions on Dublin Airport.

DAA supports the Commission in its objective to maximise economic efficiency however it is imperative that the Commission examines fully whether the proposed introduction of a theoretical proposition such as a rolling incentive mechanism will in practice deliver enhanced economic efficiency.

The introduction of a rolling incentive scheme may have the positive effect of removing any possible bias on the part of a regulated firm in regard to the timing of efficiency improvements but the scheme itself could have a potential negative impact in terms of high associated administration costs, reduced flexibility, higher regulatory risk. Therefore, the Commission must assess the potential benefits against the possible negative effects of such a scheme and it must be able to demonstrate that the marginal benefits of a particular rolling incentive scheme will exceed the associated marginal costs in order for such a proposition to be considered viable in practice.

DAA Recommendations

DAA welcomes the Commission's initiative to try to increase incentivisation within the current price cap structure and it agrees that there are strong merits in seeking possible remedies to any distortions to efficiency implicit in the current regulatory regime.

Application of Rolling Incentive Mechanism to Operating Expenditure and Commercial Revenues

DAA agrees with the Commission that operating expenditure appears to be the most obvious building block to which a rolling incentive scheme could potentially apply. It also sees some limited opportunities for the application of such an incentive scheme to commercial revenues.

Given that it is the company's policy to seek to maximise operating expenditure efficiencies where possible, DAA would like to propose to the Commission that over the course of the forthcoming regulatory determination period the company would continue to strive to identify further measures to deliver additional cost savings and/or reap greater commercial revenues and where a potential opportunity is identified this could be discussed with the Commission in detail and it could then consider the application of a rolling incentive mechanism in this context.

Incentivisation in Relation to Capital Expenditure

DAA believes that going forward it is important for both the company and the Commission to collectively seek to find ways of incentivising appropriate and efficient capital expenditure at Dublin airport in order to fulfil both the Commission's statutory objective and DAA's statutory obligations. However it does not believe that the application of a rolling incentive mechanism to capital expenditure is necessary at this time.