Dublin Airport Capex Committee (DACC) Response To CP4/2008 re Consultation on Efficiency Incentives at Dublin Airport

The DACC supports the idea of rolling efficiency adjustments in principle and welcomes the fact that the Commission is consulting further on this issue and beginning to explore the practical issues surrounding the implementation of such a scheme[1]. In our view CP4/2008 raises a number of important and valid points that need to be addressed. The DACC is concerned that the current regulatory regime creates strong incentives for the regulated monopoly to "game the system" with respect to over spending on capex and under spending on opex in order to maximise the level of its returns, at the expense of their airline customers and passengers.

We express our views below on the points raised in CP/4.

General Comments

DACC believes that rolling efficiency adjustments can play a role in increasing the incentive on DAA to bring forward efficiency savings at the earliest possible date. However, we consider them to be only one contribution to a well-functioning regulatory system. We also remain sceptical that the current system of regulation, which is a carbon copy of the UK system, is adequate to control the abuses by the regulated monopoly in terms of capex and opex gaming.

In particular, rolling adjustments should not be seen as a way of reducing the level of regulatory scrutiny on DAA. Rolling adjustment should not be allowed to become a 'cost pass-through' mechanism by the back door, or to shield DAA from legitimate commercial pressures.

Indeed, in our view it would be the case that regulatory scrutiny would need to increase if the Commission were to introduce rolling adjustments. This is because such schemes make it more important that the regulator is able to distinguish genuine efficiencies (which DAA should be allowed to retain for a specified period) from corner-cutting associated with failure to deliver the level of service envisaged in the original price determination or to build the facilities covered by the allowed capital investment plan. We refer the CAR to our comments regarding CP3 on the issue of service level agreements where users consider that the DAA is already engaged in such gaming and introducing additional charges to customers for services that were previously covered under airport charges.

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1 DACC member, Aer Lingus, wishes to point out that contrary to what CP4 seems to imply, Aer Lingus' response to CP2/2005 suggested both rolling opex adjustments *and* rolling capex adjustments. It must be pointed out however that that response did not examine the detailed implementation of such schemes.

Operating Expenditure

The Commission raises three issues on which it specifically invites comment. These are: symmetry of treatment of over- and under-performance, items to be included and passenger numbers.

These are all valid points. However, we believe that the most important issue the Commission should face in implementing rolling allowances for opex efficiencies is to distinguish genuine efficiency improvements from under-performance by the DAA. It is our view that there is a need for more than the Commission simply monitoring DAA's performance against a series of benchmarks. There is rather a need for the DAA to be subject to formal SLAs with meaningful penalties if it fails to deliver on its promised services (ref: DACC submission on CP3/2008).

In the context of rolling efficiency adjustments ensuring the *quality* of DAA's service becomes even more important. It is essential that the Commission is in a position to ensure that any under-spend relative to targets results from genuine unanticipated efficiencies rather than from DAA's failure to meet the service levels embodied in the previous determination, or, alternatively, by intentionally overestimating its opex costs during the price review process and then "finding" these "savings" once the cap is in place, thereby pocketing these costs and also benefitting from the increased airport costs. Only once the Commission is in a position to conduct this analysis would it be able to apply a rolling adjustment process to genuine efficiencies.

Furthermore, rolling efficiency adjustments should only be considered in addition to the application of challenging efficiency targets set at the periodic review. While we agree with the Commission's objective of setting DAA efficiency incentives similar to those applied by competitive markets, we note that competitive markets do not allow the retention of *any* efficiency improvement. In a competitive market efficiency improvements are occurring all the time and this leads to continued downward pressure on prices. Firms need to keep up with the general pace of efficiency improvement in order to make normal profits given the movement in market prices. Only insofar as a firm outstrips the general norm of efficiency improvements will it enjoy a temporary period of being able to charge market prices while having lower than average costs.

Our view is therefore that DAA should be set efficiency targets at the next price review that reflect a challenging view of the costs efficiencies that should be achieved. Having included these efficiency targets in price limits, only performance over and above this level should become eligible for any form of rolling adjustment mechanism.

Should under-performance be treated symmetrically with over-performance?

DACC does not believe that any rolling adjustment process should be symmetric. We are prepared to contemplate a system by which genuine efficiencies are rewarded for a period of five years. However, we do not consider that inefficiencies should be treated in the same manner. The Commission rightly notes that the regulatory system is attempting to create similar efficiency incentives on DAA to those that would be provided by a competitive market. We note however that competitive markets do not function in a symmetrical way.

In the event that a firm in a competitive market makes super-efficiency improvements, it may retain the benefit of these for a period until the rest of the market catches up. But the market does not allow firms that lag behind general improvement in efficiency to be punished for a period, and then to recover their costs. Rather, if a firm does not keep up with the general pace of efficiency improvement it will suffer permanently for its failure. The treatment of under-performance on efficiency cannot therefore be dealt with through an automatic adjustment mechanism. In the event that DAA's costs exceed predicted levels in any five year regulatory period it should be the responsibility of the Commission to identify why this has occurred.

There are a number of possibilities:

1. The Commission makes its assessment of DAA's efficiency and the reasonable costs of offering the services it does. It finds that DAA's costs are higher than predicted due simply to inefficiency. In this case the cost allowance for the next five years should be set at the efficient level regardless of DAA's actual costs. As with a competitive market, in this case DAA would never recover its inefficiency. It would be DAA's task to recover the situation by improving its performance as rapidly as possible. With a symmetric rolling adjustment, DAA would only be penalised for up to five years for its inefficiency, which is not the correct outcome; or

2. The Commission's assessment of costs comes to the view that overall efficient costs are higher than previously anticipated for some legitimate reason and that DAA is not, in fact inefficient. In this case, the higher level of costs should be included in DAA's base opex for the next regulatory period. Under a rolling system DAA would wrongly be penalised for five years for the change in costs that it could not control; or

3. The Commission's assessment of costs comes to the view that DAA's costs are higher not because costs have changed or DAA is inefficient, but because DAA is offering more, in terms of services, than was anticipated at the previous review. In this case the decision as to whether to include the costs in DAA's price base depends on whether the increase in services was justified and supported by its customers, the airlines. Only if it can be found that the airlines value the increase in DAA's outputs should the additional costs be included in DAA's base opex.

It is clear from the scenarios above, however, that in no case is simply applying a five-year rolling mechanism to inefficiency the right answer.

Should all opex categories be included?

DACC recognises that in some cases, efficiency savings can only be achieved by incurring initial costs to make those savings available. However, our view is that the costs incurred in achieving efficiencies should never be separated from or treated differently to the savings themselves. Any plan to reduce costs needs to factor the short-run costs of achieving efficiencies against their long run benefits and demonstrate a positive net present value of savings. We feel strongly that it would be wrong to treat short run costs differently from the longer run savings. To do so would increase the subjectivity of the system and likely lead to increased regulatory gaming.

If DAA were allowed to exclude from its efficiency assessment the costs of change then it would place excessive weight on the saving and insufficient weight on the costs of achieving it. A proper assessment should be based on the net efficiencies taking all costs and benefits into account. By treating all costs equally DAA has reason to maximise the value of efficiencies *and* minimise the cost of achieving them, as both strategies will increase the size of its rolling efficiency adjustment at the next price review.

Treatment of passenger numbers

The Commission raises a very good point about the impact of passenger numbers on the assessment of efficiency performance. We agree that it would be wrong to credit DAA with efficiency improvements simply because passenger numbers were lower than predicted at the last price review, or to treat DAA as inefficient because passenger numbers were higher. This means that the application of rolling opex efficiency adjustments must be done *after* adjusting DAA's outturn costs for the impact of variations in passenger numbers. However, this process needs to be carried out in a transparent and predictable manner.

However, in DACC's view the information to do this should be available to the Commission at the time of the price review. When the Commission makes its determination it has to take a view of the level of DAA's costs that are fixed with respect to passenger numbers, and DAA's long run incremental cost per passenger. This estimate of incremental cost can be used as an explicit volume factor in the formula for calculating rolling efficiency adjustments. To do this, the Commission could start with DAA's actual opex. This could then be adjusted up (or down) by the excess (or shortfall) in passenger numbers relative to the forecast at the last determination, multiplied by the Commission's estimate of incremental cost per passenger. Any out-performance adjustment could then be calculated relative to this volume-adjusted opex figure.

<u>Commercial Revenues</u>

In principle, changes in commercial revenues act on the price control in the same way as changes in operating costs, but of course in the opposite direction. For this reason there is some logic in applying a similar system of rolling adjustments to commercial revenues that has been applied to opex. However, we have significant reservations about using rolling adjustments in this context.

In the first instance, our view is that DAA already dedicates more terminal space to the generation of commercial revenues than is strictly justified or in the interests of its main customers, the airlines. Consequently we would not support a mechanism that encouraged DAA to invest even more in developing commercial revenues than it already does. It is our view that the benefits accruing from commercial revenues occur because airlines bring passengers to the airport. This is the primary justification for the Single Till. Consequently if DAA were to over-perform its commercial revenue target we do not believe that it is appropriate for DAA to retain that "benefit" for 5 years. Rather we consider that the benefit (in terms of lower airport charges) should be passed on at the earliest possible opportunity.

If, on the other hand, DAA under-performs, we think the appropriate response is for the Commission to include in the next determination the efficient level of commercial revenues, based on all the available evidence. If DAA has under-performed due to poor management then it should not receive a price increase at any point to compensate for this. If, on the other hand, DAA's performance reflects a change in view as to the potential for commercial revenues as a whole then the price control should be set accordingly.

Other points of detail

If the Commission were to introduce rolling adjustments for commercial revenue performance then it would be essential to volume adjust DAA's commercial revenue figures in a way similar to that discussed above for opex before assessing the level of outperformance. This would require the application of an estimate of unit commercial revenue per passenger – taken from the previous determination - to any unanticipated variation in passenger numbers. As regards the scope of the commercial revenues included within the rolling adjustment, the Commission will be aware of the DACC's view that certain charges, not currently falling within the price cap for airport charges, should in future become part of the regulated cap. These charges include charges for check-in desks, space rentals for installations such as self service kiosks, etc.

The rationale for including these charges in the regulated cap is that DAA has significant market power over the provision of these services and airline customers cannot readily bypass them. Including these charges within the rolling adjustment without having them in the price cap would only exacerbate this problem. In principle, DAA could beat its commercial revenue target by raising these charges to airlines, but then the rolling adjustment process would allow it to retain this "benefit" (i.e. not reduce airport charges). Thus the airlines would end up paying twice.

As a rule of thumb it would seem appropriate that commercial revenues from charges to airlines should be excluded from any rolling mechanism to avoid the problem of making the airlines pay twice. However, this merely demonstrates another complication that might suggest it is inappropriate to apply a rolling mechanism to commercial revenues in the first place.

Capital Expenditure

DACC considers that there is merit in introducing a formal rolling adjustment mechanism in the RAB, similar to that applied by Ofwat in the UK. But as with opex, the rolling adjustment should only be applied to genuine efficiencies, not to non-delivery by DAA. The rolling adjustment process therefore can only be applied after DAA's capex has been adjusted for investments that have been imprudently undertaken or not carried out at all.

Under Ofwat's system, if money is included in a company's capex plan for a particular output and that output is not delivered by the next price review, then this saving is not viewed as an efficiency saving. It is viewed as a failure to achieve agreed outputs. In these circumstances the company's RAB is immediately adjusted downwards by an amount the regulator considers appropriate. Potentially this adjustment could equal the full amount of the capex that was allowed in the first place.

DAA has a track record of not carrying out the investment included in the previous price determination or using its funds to acquire non-core assets, not related to the functioning of the airport. It is essential therefore that, before any rolling adjustment mechanism is implemented, the Commission is absolutely clear as to which outputs are or are not included within DAA's existing price limits. DAA should not be allowed to claim credit as efficiency savings that result from not delivering the outputs it was supposed to provide, nor to maintain in the RAB amounts that have been spent on non-core assets.