

Suggested Template for 'Rolling Schemes' for inclusion in the future price regulation of Dublin Airport

1. In line with standard international regulatory practice, the regime operated since 2001 by the Commission fixes in advance the levels of maximum prices that will apply for each regulatory period. Firms then have a clear financial incentive to reduce costs below the forecast levels (which, with other data, were used to compute the price caps). Since within-period cost reductions do not lead to corresponding price reductions, the regulated firm keeps the benefits of any cost savings in the form of increased profits. For the subsequent regulatory period, the regulator takes account of any cost savings revealed during the regulatory period just ended.
2. As is well known, under this approach, the length of time for which a firm keeps the benefit of savings declines with the passage of each year of the regulatory period. Savings by the firm (over and above any that were forecasted and so incorporated into the price caps) in the first year, are retained to the end of the regulatory period, and thus (generally speaking) for five years. Savings made in the second year are also retained to the end of the regulatory period; but this is now just four years. Thus the incentive to make cost savings weakens during the price control period.
3. A number of regulators have overcome this arbitrary attenuation of savings incentives by maintaining a uniform reward for cost savings over the complete regulatory period. The methods used have come to be known as 'rolling incentives mechanisms' because they 'roll forward' for a defined interval the reward for cost savings, regardless of whether the firm makes the savings early or late in the regulatory period. Details of a possible scheme, based on the approach of the UK water regulator (Ofwat) are summarised below.¹
4. The Commission wishes to introduce such a rolling incentive scheme for Dublin Airport, to apply to operating costs. This would allow the DAA to retain efficiency savings in excess of regulatory assumptions of opex for five² years, irrespective

¹ See Annex A of the March 1999 Ofwat paper MD145 "The Framework for Setting Prices" available at [http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/annexa.pdf/\\$File/annexa.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/annexa.pdf/$File/annexa.pdf). See also the more comprehensive, though also more complex, rolling scheme proposed by Europe Economics in "Rolling Schemes in Price Control Reviews", June 2003, available at <http://www.eer.co.uk/download/eerolling.pdf>

² Or for six years if opex data, to allow the computation of a price cap set to commence in year t, were available on an audited basis only for the year t-2.

of when such savings are made. The savings would be retained via an incentive allowance, which would be calculated by the rules such as those set out below. Note that a rolling incentive mechanism and incentive allowance will only affect the price caps for Dublin Airport from the start of the next regulatory period, i.e. 2010.

5. The Commission also favours the introduction of a rolling scheme in respect of commercial revenues as well as for capital expenditure. In the latter case, where the design of such a mechanism would be complex, careful analysis and industry consultation would need to precede the introduction of a rolling efficiency scheme.
6. By its nature, a rolling incentive scheme compares a company's *forecast* opex with its *actual* opex; the difference (if the actual is below the forecast) is deemed to be an efficiency improvement. Such a scheme can only operate as intended on the basis of a robust forecast of a firm's operating costs; otherwise differentials measure forecast errors as well as efficiencies.
7. A robust opex forecast is not at present available for Dublin Airport. Considerable uncertainty attaches to the DAA's investment programme and budget at the airport. Because new facilities impact on the operating costs at those facilities, capex uncertainty implies opex uncertainty. Therefore, the Commission has been unable to introduce a rolling incentive scheme as part of this Determination. Nonetheless, possible rules for such a scheme are set out in this Annex in order to facilitate engagement by interested parties with a view to incorporating a rolling scheme into the Dublin Airport price regulatory regime at the next practical opportunity. The views of interested parties are therefore actively sought on the possible scheme outlined below.
8. Define the regulatory period 2006-09 as financial years 2006, 2007, 2008, and 2009, and regulatory period 2010-14 [?] as financial years 2010, 2011, 2012, 2013, and 2014. For any financial year t , R_t is the regulatory assumption of OPEX for financial year t , C_t is the actual OPEX in financial year t , n_t is the difference between R_t and C_t (out-performance) in financial year t or zero if the difference is negative, i_t is the incremental out-performance in financial year t relative to that achieved in all previous years in the same five-year price review period:

$$i_t = n_t - n_{t^*} \tag{1.18}$$

where n_{t^*} is the highest previous level of out-performance achieved in any year in the Regulatory Period 2006-10. i_t is zero if n_t is less than n_{t^*} .

9. Define the regulatory period 2006-09 as financial years 2006, 2007, 2008, and 2009. There is an extra constraint on i_t , where the sum of i_t for all the first four financial years in Regulatory Period 2006-10 should be the level of out-performance achieved in the fourth year:

$$i_{06} + i_{07} + i_{08} + i_{09} = n_{09} \quad (1.19)$$

10. This constraint ensures that the incremental out-performance feeding into the incentive allowance (IA) is genuine and sustainable out-performance that should be rewarded.

11. IA_t is the incentive allowance for financial year t, which cannot be less than zero since all i_t are, by definition, at least zero. The incentive allowances for Regulatory Period 2011-15 are calculated as:

$$IA_{11} = i_{06} + i_{07} + i_{08} + i_{09} \quad (1.20)$$

$$IA_{12} = i_{07} + i_{08} + i_{09} \quad (1.21)$$

$$IA_{13} = i_{08} + i_{09} \quad (1.22)$$

$$IA_{14} = i_{09} \quad (1.23)$$

$$IA_{15} = 0 \quad (1.24)$$

12. The company therefore retains the benefit of each incremental out-performance for a total of six years.

13. To illustrate, an example of calculating IA for a Regulatory Period 2011-15 at the time of next price review is given by the Table below.

Table: Example of the Calculation of an Opex Incentive Allowance (IA) for a Regulatory Period 2010-15

OPEX		Regulatory Period 2006-10						Regulatory Period 2011-15				
Financial year		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1	Regulatory assumption	275	270	265	265	260	255					
2	Adjusted actual expenditure	265	255	250	240	230	?					
3	Out-performance (OP)	-	15	15	25	30	?					
4	OP (setting negative to zero)	-	15	15	25	30	?					
5	Incremental OP in 2006 (i_{06})		15	15	15	15	15	15				
6	Incremental OP in 2007 (i_{07})			0	0	0	0	0	0			
7	Incremental OP in 2008 (i_{08})				10	10	10	10	10	10		
8	Incremental OP in 2009 (i_{09})					5	5	5	5	5	5	
9	Incremental OP in 2010 (i_{10})						-	-	-	-	-	-
10	Incentive Allowance (IA)							30	15	15	5	0

14. The UK Civil Aviation Authority (CAA) has employed a variant on the Ofwat rolling efficiency scheme for the regulation of National Air Traffic Services (NATS).³ Under that scheme, the incremental allowances are calculated as before, and their present value is added to the regulatory asset base at the start of the following price control period. At the time of the establishment of its scheme, the CAA also envisaged the development of safeguards to maintain the relative incentives for opex versus capex efficiencies, and to avoid arbitrary distortion to the timing of expenditures.

15. An issue that is partly related to a rolling opex efficiency scheme concerns the up-front costs to a company (the 'redundancy payments') associated with a staff severance scheme, such as the former Aer Rianta's Voluntary Severance Scheme

³ See paragraphs 6.39 to 6.44, and Part 5 of Annex 4, to the CAA report of March 2003 on the "NATS Application to Re-Open the Eurocontrol Charge Control" at <http://www.caa.co.uk/docs5/ergdocs/natsdecisionmarch03.pdf>.

announced in the company's 2001 Annual Report.⁴ The former Aer Rianta, and latterly the DAA, has argued to the Commission that the forecast of the operating costs of Dublin Airport should include provision for the up-front costs of the company's VSS. For example, at the time of the 2-Year Review, the Aer Rianta submission proposed that airport charges be adjusted upwards to take account of the cost of the company's VSS. In its subsequent determination, the Commission rejected the former Aer Rianta's representations, on the grounds that the "redundancy programme is an endogenous matter to the regulated firm and including its costs in the price cap at this time would considerably weaken the incentive effects of the price cap."⁵

16. In its submission on the draft 2005 determination, the DAA repeated its view that, in principle, were the company in the future to engage in a further VSS, the associated up-front costs should be funded through the price cap: "Adequate provision must be made to cover the costs associated with the operation of a voluntary severance scheme within the regulatory Determination if headcount reductions are assumed".⁶

17. The Commission notes that an opex rolling efficiency scheme, by giving the company the benefit for a full regulatory period of any recurring savings from a VSS, would increase the incentive for the DAA to pursue opex efficiencies, including by means of a future VSS. More generally, the Commission envisages that it will analyse, and adopt policy regarding, the appropriate treatment of up-front VSS costs in the context of future engagement with the industry on rolling efficiency schemes, with a view to the regulatory regime being such as to give the regulated firm strong incentives to pursue efficiency.

⁴ The DAA scheme involved a total nominal cost of €20.9 million and saw 153 persons leave the employment of Dublin Airport by the end of 2005.

⁵ See CP2/2004, page 80.

⁶ The DAA expressed this view on page 10 of their response to Commission Paper CP2/2005, 1st July 2005. The DAA did not supply the Commission with any forecasts or estimates of the costs that it might be expected to incur in 2006-2009 in regard to a VSS scheme.