Draft UK Reference Period 3 Performance Plan Proposals

1. This submission is made by International Airlines Group, SA (IAG) in response to the CAA's consultation of February 2019 on its initial proposals for the economic regulation of NATS En-Route Limited (NERL) (CAP1758). It sets out the initial views of IAG and its subsidiary airlines: British Airways, Iberia, Vueling, Aer Lingus, LEVEL and IAG Cargo.
2. It does not seek to comment on every point raised in CAP1758 - rather, it focuses on what appear to be the key issues; however, we may subsequently comment on others.
3. For ease of reference, it will broadly follow the structure of CAP1758.

Executive Summary

4. We accept neither 'spill' nor 'allocation' traffic forecasting models, but support the CAA's use of the STATFOR approach, as well as its adoption of more ambitious performance targets that required by the EU, particularly regarding safety, which is the most important consideration.
5. We support the use and proliferation of 3Di environmental indicators, which are preferable to two-dimension approaches, and encourage their rigorous application; however, do not support bonus payments for meeting performance expectations. We also support the continued application of capacity KPIs, but believe these should require improvement and should not be subject to uncontrolled exemption days.
6. Both NERL's overstated forecasts of operating costs (predicated on an ATCO labour market that requires structural reform) and its reluctance to inform on non-regulatory revenues, should provoke a rigorous response from the CAA. We recognise the incongruity of pension costs and NERL's overstated capital plans – and broadly support the CAA's approach to both, except for unnecessary contingency arrangements.
7. We do not believe sufficient rigour has been applied to NERL's overall costs.
8. We agree with the CAA's approach to financeability and support its assessment of NERL's creditworthiness, ability to access financial markets and WACC; however, are nevertheless concerned about how the CAA is thinking about the RAB.
9. We do not believe that Biggin Hill approach services should be regulated.
10. We are broadly content with existing risk-sharing mechanisms (and encourage the CAA to resist the EU's abdication of meaningful performance targets); however, do not agree that various operating and capital contingency funds are appropriate.

11. We agree with the CAA that TANS at LCY should remain regulated, but consider its proposed targets for ATFM delays at London airports to be inadequate.

12. We share the CAA's deep concerns with the ownership structure of Aireon, which is to provide ADS-B oceanic services, as well as the lack of transparency of charging structures, potential fuel savings, cost/benefit analysis or credible traffic forecasts.

Introduction & Context

13. We are grateful for the CAA's description of the **regulatory context** and summary of interactions between the Single European Sky Performance and Charging Scheme (SES PCS), the Transport Act 2000 (the Act) and 'Brexit'. We agree with the CAA that, irrespective of political uncertainties, the substantive requirements of economic regulation will be similar, whether they ultimately fall under the Act or the SES PCS.

14. We agree with the CAA and Government that **airspace modernisation** is a key strategic consideration, so will respond to the Green Paper accordingly and in due course.

15. We support the CAA's use of STATFOR **traffic forecasts** and agree that the figures presented in CAP1758 should be updated, as these are revised over time. In our view, the STATFOR approach is balanced and produces realistic outcomes. If passengers are 'priced-off' some airports, some would fly from alternative airports, others would use alternative transport modes, whilst still others would not travel at all.

16. Whilst accepting the CAA's view that STATFOR is more applicable where alternative modes are more readily available, as a strict matter of policy we agree with neither traffic allocation models nor arbitrary labelling of passengers. These represent outdated 'BAA-era' thinking, which have repeatedly proven to be (at best) unreliable.

17. Passengers do not somehow 'spill' from one airport to another as a result of capacity constraints; the economics are far more complex. Neither can arbitrary labels applied to passengers to predict their behaviour. However it all breaks down, passengers display a range of price-sensitivity and propensity to engage alternative modes of transport, be that surface access to alternative airports or for the entirety of a journey.

18. In our view, **EU performance targets** continue to be worryingly unambitious and damaging to aviation. Therefore, we continue to support the CAA's approach in setting targets for NERL that are (at least) not self-fulfilling. Of course, we realise that should the EU come forward with targets that put any pressure whatsoever on ANSPs, then the CAA would need to react accordingly; however, it is not an eventuality we envisage.

Safety

19. Safety is the most important consideration, which we are not willing to see compromised under any circumstances – and so will respond to the Green Paper accordingly and in due course.

20. We recognise that challenges come with the introduction of new technology and airspace modernisation. NERL must at least maintain current safety performance at 'Level D', for both safety culture and management objectives.

21. We therefore agree with the CAA that it is appropriate for NATS to develop and implement internal **aspirational safety targets**, which exceed those set by the EU – and that NERL should report performance against these through the SIP.

Environment

22. We recognise that there are limits to how effective NERL can be in mitigating environmental impacts and agree with the CAA that it must be reasonable and practicable.

23. The **3Di environmental indicator** used by NERL and favoured by the CAA is markedly preferable to the two-dimensional KEA performance measure, in place elsewhere in the EU. We therefore welcome not only the continuing use of 3Di, but also the CAA's support for its wider adoption, throughout the EU.

24. Noting that the 3Di target is subject to a 'deadband' and was incrementally increased over RP2, NERL consistently failed to achieve its target (nevertheless, demonstrating some marginal improvement), importantly, avoiding penalties. Without suggesting that NERL has been engaging in this type of behaviour, the CAA will doubtless be conscious of the potential for **regulatory gaming**, wherein if a regulated firm considers the current value of potential bonuses to be not worth the future cost of stiffer targets, it may seek to perform just above the upper bound of a deadland, the objective being to disincentivise a regulator from stiffening targets.

25. The only evidence (of which we are aware) is entirely circumstantial; NERL's proposal to maintain RP2 3Di targets (subject to certain, not insignificant, mitigating adjustments) into RP3. Whatever the truth of the matter, the CAA should be aware of this regulatory context and not allow NERL's RP2 performance to unduly influence its RP3 targets.

26. We welcome the CAA's proposal to disallow NERL's proposal to exclude from 3Di performance targets certain factors it considers to be out of its control: **diversions (due to runway closures); vertical cut-offs; volume of airspace/accuracy of data; and variations in levels of traffic**. In particular, we agree with the CAA that NERL's vertical

cut-off proposal would be inappropriate and damaging – and in fact, would simply subordinate NERL's efficiency objectives to those of noise impacts.

27. The overarching point is that, as the CAA rightly suggests, service quality regulation exists to align the interests and experiences of monopoly suppliers with those of their customers. In normal markets, suppliers regularly experience adverse circumstances, which are out of their control; it is a normal part of business – and whilst suppliers may suffer in the short-term, they persevere and continue to provide for their customers.

28. All the factors proposed by NERL are equally out of airlines' and passengers' control, yet (in this regulated environment) it is they who bear the brunt of consequential costs. It would therefore be quite wrong for NERL to be paid by its customers for services it hadn't delivered, irrespective of 'guilt'; actual, perceived or otherwise.

29. If the CAA decides (for philosophical reasons) to remove **non-revenue flights** from service quality regulation in RP3, then we agree that it must make appropriate adjustments to 3Di targets.

30. The CAA states that removal of non-revenue flights would require a 0.6 downward adjustment in **par values**; however, this is not reflected in the figures put forward. The par value for the last year of RP2 (2019) is shown as 27.1 and the opening par value for RP3 (2020) is 26.8. So, it appears to us that there is an annual 0.3 decrease in par values across RP3, including in 2020, but that the 0.6 decrease has not been applied. In our view therefore, the par values implied by the CAA for RP3 are: 2020, 26.2; 2021, 25.9; 2022, 25.6; 2023, 25.3; and 2024, 25.0.

31. We support the CAA's position regarding **consistent reporting methodology**, ensuring that changes in 3Di scoring relate to performance and nothing else.

32. Whilst (in the wider context) we understand the CAA's proposal for **penalties and bonuses** at +/-1% of determined costs, in principle we are opposed to bonuses. The reward for achieving targets ought to be a fair return and the penalty for not achieving target ought not to be. That is how efficient markets work and the CAA should be seeking to mirror efficient market outcomes in its regulation of NERL.

Capacity

33. We welcome the CAA's comments - in particular, the recognition that *"… it is NERL's responsibility to deliver a quality service…"* Too often, rather than solutions, regulated firms seek exemptions - and so it is refreshing that the CAA is taking a balanced approach. That said; in our view, maintaining RP2 capacity targets into RP3 is conservative (at least) and arguably somewhat generous to NERL. Nevertheless,

considering system changes and the redesign of airspace, we accept that this should be the case.

34. Regarding **SES requirements and capacity KPIs**, the CAA will be aware that in April 2019, the weakest levels of ambition in the history of the SES PCS were approved by EU member states. In summary, the EU has reduced ATFM delay targets from (an already weak) 0.5 minutes to a quite pathetic 0.9 minutes. Instead of facing up to severe capacity problems, the SES PCS has simply relaxed the targets, so performance doesn't appear to fail so badly!

35. It would be quite unacceptable for the UK to follow the EU's abdication and so we cannot support the CAA's suggestion that it will *"… engage with the PRB and the Commission […] before setting the C1 target…"* Rather, we support the CAA's proposal for the maintenance of an **average ATFM delay target of 0.23 minutes**. This was proposed by NERL, supported by airspace users and proposed by the CAA – and nothing that happens at EU-level could possibly change its relevance.

36. Passengers don't differentiate between causes of delays. It makes no difference to them whether they're stuck at an airport because of an ANSP staff-shortage, airspace congestion down-route or weather-related issues. In all cases, it is airlines which must shoulder the costs of delay and so we disagree in principle that **financial incentives** should be applied only to C2 metric – that of **ANSP-attributable delays**.

37. That said; we recognise that this approach can be an effective incentive mechanism (as opposed to one of balance/redress). What is nevertheless clear is that a target of 0.18 minutes is not stretching, when between 2015 and 2017 NERL achieved an average C2 delay of less than 0.12 minutes – and *"is forecast to outperform the target in 2018"*. As the CAA says, *"… our analysis of NERL's historical performance suggests NERL could achieve more ambitious C2 performance."*

38. Notwithstanding the CAA's proposal for a deadband between 0.15 and 0.21 minutes, there is absolutely no benefit in paying bonusses to NERL for achieving performance levels fully a third below those it currently achieves. All this could do would be to put additional and unnecessary costs onto airlines and passengers. So, whilst we may be content to accept the CAA's proposal for an **ANSP-attributable ATFM delay target of 0.18 minutes**, it would have to be on the basis that any financial incentive applied to this was purely asymmetrical, in the form of penalties only. If the CAA desires a degree of symmetry in a bonus/penalty arrangement (as it proposes), then this cannot be around any number greater than 0.12 minutes of ANSP-attributable delays.

39. Noting the significant difference in impacts arising from penalties applied to NERL and airlines/passengers' consequential costs, we broadly support the CAA's proposal to increase the **proportionality** of financial incentives, relative to determined costs.

40. Whilst we are generally supportive of improving performance measures, it is difficult to understand quite what the CAA thinks can be achieved by lowering the thresholds for the C3 impact score for **long delays** from 16/24 to 14/22 – or equally, lowering the **severe disruption** C4 threshold from 2,000 to 1,800. NERL's RP2 performance has been a very long way ahead of both these measures, the triggering of either of which would represent very significant disruption to airlines and passengers, so it could be hoped that the CAA might show a little more ambition.

41. We are broadly supportive of an approach that replaces exemption days with a **transition allowance**, targeted at three specific RP3 transitions: DP en-route; DP lower; and LAMP. We nevertheless share the CAA's concerns over NERL's proposals. In particular, the idea that the transition allowance would apply to C1 and C2 measures is unacceptable, as is the idea that delays below the metric would be 'written down'.

42. What the CAA means by a **cap of 75 days** is slightly unclear. If (as it seems) it means that in advance of RP3 NERL should propose a transition allowance with a defined number of **exempt days**, each with a defined purpose relation to a specified **period of transition**, not exceeding 75 days in toto, then we would support the proposal. To be clear, this would mean that should agreed exempt days within any defined period of transition turn out to not be required, they would be spent regardless – and could not be reallocated to future periods of transition.

NERL RP3 Costs

43. Noting that *"NERL has said that increases in its costs are driven by growth in traffic…"* (and other unspecified changes) it is hard to see how this could justify the increases in **operating costs (excluding depreciation and pensions)** it forecasts. For example, it suggests that **wages and salaries** go from an average of £238mpa in RP2 to £256mpa in RP3 – an increase of 7%. Even more stark is the suggestion that **non-staff operating costs** go from £141mpa to £174mpa – an increase of 24%. Overall, NERL's proposal increases costs from £350 in 2017 to an average of £431m across RP3 – an increase of 23%.

44. We are therefore supportive of the CAA's work with Steer/Helios, which *"… suggests there may be scope for NERL to consider more ambitious efficiency targets."* We could not have put it more mildly ourselves! We also agree with the CAA that NERL's investment in new technology should drive efficiencies and don't believe it is enough

for the CAA to say that *"… it is not clear that such opportunities are fully reflected in NERL's business plan."* The CAA's must regulate in a way that does reflect these opportunities.

45. It is unsurprising that NERA would say that their principal's *"wages are broadly in line with market benchmarks."* The independent Steer/Helios report, on the other hand, concluded, concluded that they *"…were high relative to other comparable jobs but in line with other European ANSPs…*".

46. The Steer/Helios conclusion is entirely consistent with our view that the **labour market for ATCOs** is distorted. If **ATCO training/qualifications** were available from a wide range of providers (universities and so forth), rather than just from NATS, it would liberalise the ATCO labour market, address the chronic problem of staff shortages and bring down operating costs.

47. Contrasting ATCO training with pilot training, would-be pilots usually finance themselves through a two-year training programme, before (if successful) applying to airlines and type-rating. In this way, they participate in a self-regulating labour market, in which salaries are a product of the supply of pilots and demand for their services.

48. Trainee ATCOs, on the other hand, are employed by NATS from the outset of three-years training and subsequent deployment, so what amounts to a 'pipeline' of ATCOs, in which the supply of labour is both inflexible and constrained, is financed through ATC charges, paid by airlines. In the past, various ANSPs have said that only they 'know their airspace' and so only they can provide training; however, sector-specific ATCO training is broadly analogous to pilots' type-rating – and could be delivered in the same way.

49. In our view, the CAA should take concrete steps to liberalise the ATCO labour market.

50. Independent to the potential removal of EU funding, NERL's forecast costs continue to increase every year, throughout RP3. The reasons are difficult to understand, because information that might have justified this has not been made available. It appears to us that the CAA has suffered from a similar lack of transparency and so has been forced into a mechanistic approach to capital efficiency.

51. Nevertheless, from what we know, the CAA's proposal to remove £71m from NERL's business plan appears to be broadly reasonable.

52. We understand that NSL's provision of TANS is excluded from consideration in the CAA's assessment of NERL's **non-regulatory revenues and costs**.

53. It is worth noting CEPA's conclusion that: *"… [in forecasting intercompany revenues] NERL's processes for identifying commercial opportunities and charging a market-based return could be more transparent."* That these same issues were identified at RP2 and

are still to be addressed speaks volumes – and suggests that a forecast *"… reduction in some of its non-regulated income streams"* may not materialise.

54. We further note that *"… NERL has not provided detailed information as part of its RP3 business plan"* and in response to the CAA's request for supplementary information on this question, *"… NERL has provided little substantive addition information"*. In our view, under these circumstances the CAA would be perfectly reasonable in drawing from NERL's behaviour whatever conclusions its sees fit. For this reason, we support the CAA's proposal for an upwards adjustment to NERL's forecast non-regulated revenues; however, note that it is only half NERL's proposed reduction and therefore consider that NERL may well be very satisfied with this outcome!

55. Noting the CAA's further request for information and accompanying suggestion that in its absence, further revenue adjustments may be made, it is clear that whatever justification (if any) NERL offers up must be rigorously tested and cross-referenced against other parts of the RP3 business plan.

56. It would be very much in NATS' commercial interests to cross-finance its businesses, because it could increase the scale of (and unregulated revenues from) NSL, whilst covering the costs of NSL's expansion with increased regulated revenues from NERL. We therefore note with interest that *"revenue from activities that NERL undertakes from intercompany transactions with NSL is projected to decline over RP3 due to a reduced pipeline of expected work from NSL…"* NSL's non-regulated revenues (excluding TANS) have consistently exceeded RP2 projections – and in 2017, by as much as 20%. It is therefore somewhat incongruous for NERL to suggest that non-regulated revenues will fall by over 15% by the end of RP2 – and will continue to do so across RP3.

57. On a related issue, even if it was the case the there was no misallocation of NSL's costs to NERL, creditworthiness is manifest at corporate, not divisional, level. So NSL – which exists in a reputedly 'competed market', enjoys access to lower cost capital than would otherwise be the case as a direct result of its association with NERL.

58. We recognise (and agree with) the CAA's candid assessment of NERL's **pensions** – and have little to add, other than to reiterate the stark contrast in arrangements enjoyed by NERL employees in comparison with those of NERL's customers. *"More generous"* is one way of putting it – and there are doubtless many others; however, we recognise the regulatory constraints put in place by the Transport Act 2000.

59. For these reasons, we support the CAA's consideration of the level of prudence assumptions in the **DB scheme** valuation and consequential reduction in determined costs of £36m, as well as the application of broader operating efficiency assumptions, reducing the determined costs of both the **DB and DC schemes** by a further £12m.

60. In principle, we would not be averse to the CAA issuing a **regulatory policy statement** regarding NERL's pension costs; particularly, as the CAA rightly points out, there are interactions with capital markets - and hence, the **regulated rate of return**. Before taking a definitive view, however, we would need to better understand what the CAA intends.

61. The history of NERL and its five-year **capital investment plans** can be summarised as one of perennial replacement of old technology, with customers bearing perpetual costs of a never-ending transitional phase!

62. As the CAA introduces this topic for RP3, it makes the same observation: *"… airspace changes planned for the last year of RP3 could slip into RP4…"* and *"… NERL proposes a capital investment programme with a similar investment level to RP2."* This is confirmed by Steer/Helios, which states that *"… replacement of old systems is the central benefit driver of RP3…"* and unhappily (if predictably) *"… many of the benefits are predicted in RP4 and beyond."*

63. Steer/Helios makes the succinct point that £750m – 830m forecast expenditure for the **DSESAR programme** has been retained, despite that the project has been largely superseded by **ExCDS**. It is simply unacceptable for NERL to somehow 'forget' to remove £750m – 830m from its CAPEX plans – and it should send a string signal to the CAA about NERL's approach to capital forecasting.

64. Steer/Helios goes on to note that *"… there is insufficient detail provided on the capital programme in NERL's business plans to assess, for example, the sub-programme benefits."* We would contend that it is unlikely that papers submitted to NATS board seeking approval for this investment were in any way lacking in sufficient detail.

65. We are inclined to accept NERL's forecast for **airspace modernisation** of £115m and **contingency** costs of £34m, not because we are convinced that the figures are reasonable, but rather because we do not wish to provide NERL with an excuse for failure in these two critical areas. For the avoidance of doubt, we are keen to see airspace modernisation.

66. Turning to **DSESAR**, **technical resilience**, **service improvement** and **business resilience**, in light of NERL's failure to provide transparency on (or justification for) these capital investment plans, we support the Steer/Helios proposals for the following respective reductions: £299m to £220m; £144m to £124m; £37m to £30m; and £88m to £55m.

67. Noting that the CAA has proposed a much gentler approach, reducing NERL's planned investment costs from £715m to £667m (£48m), rather than the £715m to £579m (£136) proposed by Steer/Helios, we consider that it is incumbent on the CAA to

constrain NERL's consistent attempts (hitherto successful) to game the regulation. We are particularly looking forward to the CAA's ex-post review of RP2 capital expenditure.

68. We agree with the CAA's summary that *"… NERL's governance arrangements are insufficient to provide airspace users and other stakeholders with an appropriate degree of comfort with respect to its capital expenditure plans."* Consequently, we welcome the Independent Reviewer's four proposals for **enhanced arrangements** in NERL's processes: firm baseline; regular updates; broadening the scope of independent oversight; and a licence modification, allowing the **CAA to opine on NERL's SIP**.

69. Therefore, we disagree with the CAA on this final point. In our view it is precisely the role of a sectoral regulator to guide a regulated firm (with as firm a hand as may be necessary), should it begin to drift from its allotted course. There is nothing in this proposal that would mandate the CAA to comment – and it is difficult to understand why the CAA would wish to fetter its future ability to do so. It is worth adding that whilst the CAA has become increasingly consumer-focussed its regulation of airports, the same cannot be said for its regulation in the NASP environment.

70. We support the CAA's proposals for a specified **escalation mechanism** and an **enhanced role for the Independent Reviewer**. We are particularly pleased to note that the CAA has proposed that RP3 overspend (should it pass efficiency thresholds) will be remunerated only at the **cost of debt**. This mechanism goes some way towards reflecting competitive market outcomes and we would encourage the CAA to adopt a similar philosophy across wider policy areas.

71. In principle, we support the idea of putting NERL under a licence obligation to *"… support and drive forward airspace modernisation"*; however, are unclear as to how this might be constructed. There is an obvious interaction with the Green Paper proposals for the introduction of new Statutory Instruments. It will be important to ensure that any new obligations placed on NERL are consistent with existing licence conditions and that they do not undermine performance and efficiency objectives.

Overall Costs

72. Whilst the CAA accurately summarises the declining importance of civil aviation in the work of the **Meteorological Office**, it is unclear that a commensurate degree of financial rigor has been applied to its forecasts. For example, neither the size nor (other than that it is to provide 'weather resilience') role of the meteorological team located within the Swanwick Area Control Centre is specified. Perhaps more importantly, the CAA does not say when the *"Met Office web tool"* will become available, or what savings this will bring.

73. Similarly, describing development costs of the UK contribution to **ICAO WAFS** as *"approximately £10m"* and the benefits as *"significant efficiencies through reduced manual resourcing"* does not foster feelings of confidence that a proper business case analysis has been undertaken.

74. We recognise that the **DfT** has no direct control over the proportion of UK contributions to **Eurocontrol** and that a £3m surplus in 2017 will be applied in RP3. That this surplus is only partially recovered in RP3, indicates that despite UK pressure on Eurocontrol's costs, the underlying cost trend remains upward, both in real and nominal terms.

75. The **CAA** forecasts an increase of staff costs from £4.4m in 2019 to £10.7m in 2024, with the biggest year-on-year increase being from 2019 to a cost of £8.2m in 2020. The somewhat vague justification provided for this 143% hike is *"largely driven by the current and expected growth in **Airspace Change Proposals** (ACP)"*. A rough calculation suggests that from an increase in ACPs from 12-15pa in 2013/4 to 82 in 2018, then the cost of the CAA's consideration is £55.5k per ACP.

76. For reasons similar to those set out above, it is entirely incongruous that the CAA should apply a charge of £6.0mpa on NERL – a firm subject to the CAA's economic regulation, in order to fund its own **pension shortfalls**. This is ultimately paid for by airlines and passengers, the majority of whom (as is the case throughout the majority of the developed world) are unable to access such benefits.

77. We do not agree with the CAA's policy of passing through £10m costs of an **AMS support fund**, in advance of the identification of any specific requirement. If any such need is identified and agreed in RP3, then funding can doubtless be found – through RP4 charges, most likely. Such an approach would be standard regulatory practice and so it is hard to understand what has motivated the CAA to pre-finance this unknown and unspecified requirement.

78. The PRB has proposed EU-wide **cost efficiency targets** of 4.1%pa across RP3, but without seeking justification, the CAA has proposed a notably weaker target of 3.8%.

Financeability

79. We understand that NERL (technically NATS) requires **access to financial markets**, in the manner that the CAA describes and support approaches which aim to ensure this is achieved at the lowest possible cost to airspace users.

80. The CAA's description of the **RAB** as *"a measure of the amount invested"* is concerning; the RAB ought to be a congregation of approved capital assets at their depreciated cost. Just in the way that if the CAA approves a bad investment, airspace users experience

less than anticipated value, if a good investment is approved, they may experience more value. The point is that the regulatory contract is supposed to symmetrically indemnify NERL from the consequences of its investment decisions.

81. That is all well and good, but when the CAA drifts away from this strict definition – or worse, talks about 'value' (as opposed to cost) of investments (as it now does in relation to airports), it is loses perspective and balance. It is wholly unacceptable for airspace users to be required to pay the full cost of bad investments and the full value of good ones. This approach would create a risk profile for NERL entirely on the upside – and could potentially indicate a negative WACC.

82. We understand the CAA's treatment of **forecast RAB values** across RP3, but any positive impact of the CAA's adjustment of NERL's forecast capital programme on airspace users will be modest; albeit, long-lived. We would support Grant Thornton's suggestion of *"a comprehensive guide for model calculations"* and would very much like to be involved in its development.

83. When the CAA describes *"true-ups"* applied to **regulatory depreciation** arising from capital investment in previous review periods, it is unclear whether it has also adjusted for 'true-downs' or whether, in fact, NERL has always overspent its capital allowances.

84. We are not surprised that NERL has proposed a high **WACC allowance**; however, in today's climate, the suggested pre-tax 5.07% is quite brazen, even for NERL! We are consequently encouraged that the CAA recognises the *"… strong evidence pointing to a sharp reduction in the pre-tax WACC since RP2…"*

85. The CAA's estimate of NERL's pre-tax WACC of 2.84% concurs with the November 2018 CEPA report into **NERL's cost of capital**, concluding that this falls in the range 2.16 - 3.28%, to which the CAA helpfully refers. The wide disparity between, on the one hand, NERL's forecast and supporting NERA report, and on the other the CAA's estimate supported by CEPA should provide sufficient indication as to what is real, what is not, and a distorted view which may stem from vested interests.

86. In any case, we agree with NERL that *"… it should be able to retain a strong investment grade credit rating and cost-effective access to new finance"*; although, wonder how it could hold this view concurrent with one that its pre-tax WACC should be 5.07%.

87. In our view, the degree of **stress testing** applied to NERL's business plan is too extreme. The likelihood of a 10% drop in traffic in every year of RP3 is vanishingly remote, as is a 5% reduction in traffic in combination with a 2.5% increase in operating costs. Notwithstanding that under the test covenants remain unbreeched, even in the absence of management action, quite how the CAA arrived at these scenarios is unexplained and so our assumption is that they are quite arbitrary.

London Approach

88. We do not oppose the proposal to include Biggin Hill in the scope of the regulated London Approach charges

89. We understand (without necessarily agreeing with) NERL's inclusion of two demand variables in its proposals and look forward to working with NERL and the CAA to identify suitable **performance metrics** for RP3.

Uncertainty Mechanisms

90. We consider that the CAA has adopted a balanced and reasonable approach to NERL's management of **uncertainty of airspace modernisation**, sharing risks and so maintaining NERL's status as a *"low risk business"* and consequential access to low cost financing, with everything that entails. Equally, we recognise and agree with the CAA characterisation of **traffic growth risk sharing** and its systematic dimensions.

91. Accepting the principle that risk should be allocated where it can best be managed (and that this has a reducing effect on NERL's WACC), we are broadly content with the CAA's proposal to maintain RP2 **risk-sharing mechanisms** into RP3; specifically, these being the +/- 2% deadband; the +/- 2-10% 70/30% users/NERL share; and the +/- 10%+ 100/0% users/NERL share.

92. We are familiar with the European Commission's propensity to relax already weak targets, in circumstances where regulated firms have failed to achieve these, but do not consider it to be an effective approach to improving performance. With this in mind, we would not support the CAA's proposal that it will consider revising performance targets should **alert thresholds** be triggered. Targets are targets – and if there was no possibility of them being missed, then they would be something else!

93. NERL is reimbursed for the **cost risk** it bears through the regulated rate of return and requires no further indemnity. The European Commission refers to the risks identified by the CAA as 'uncontrollable'; however, in our view, there is a significant difference between what is genuinely uncontrollable, and what has been decided to not be controlled.

94. We disagree that a ***"capital expenditure contingency"*** should be allowed into the RAB. First, 'contingency' is risk - and NERL is already compensated for this through the regulated rate of return. Second, there are far more suitable mechanisms for dealing with this type of contingency, such as ex-post CAPEX triggers and/or subsequent post-

financing. And third, the CAA knows that once something finds its way into the RAB, airspace users will pay for it forever, even if 'it' (as is likely) turns out to be nothing.

95. For similar reasons, we also disagree with NERL's proposal for an *"…**Opex Flexibility Fund (OFF) of £35m**…"*, which is suggested would replace the RP2 FAS Facilitation (NERL) Fund, which was £15m.

96. Making addition funds to those identified as being required available to NERL in this way would negate most of the benefits that effective economic regulation might bring.

97. The CAA has already (and generously) allowed NERL its full proposed costs for **airspace modernisation**, despite identifying (and removing) considerable operating cost over-forecasts for similar work – and for different reasons, we have supported this approach. If the CAA is now going to provide NERL with £35m OFF, then it had first better revise and realign its approach to NERL's business plan operating costs for AMS. As the CAA rightly points out, it is *"… appropriate for NERL to meet its obligations and provide its services, and it is for NERL to manage its business within the revenue we have allowed."* The CAA must adopt the same philosophy when considering the proposed £10m **AMS Support Fund**.

98. It is quite unprecedented for a regulator to allow full operating costs of a regulated firm's specific plan (not least, when it is generally acknowledged to be overstated); then to establish a second contingency fund, within which the plan is in scope; and then to set up a third 'earmarked' fund for precisely the same narrow purpose. We object!

Terminal Navigation Services

99. We recognise the CAA's description of the EU and UK contexts for **TANS** and agree with its view that pragmatically it is sensible to retain LCY under performance regulation, even though it currently falls marginally outside a revised volume threshold.

100. There is a potential disconnect between the **environmental KPIs** applied to NSL's provision of TANS – or at least, the connection is unclear. The CAA does not explain how the measurement of additional taxi time, time in terminal airspace or share of arrivals applying CDO translates into incentives on NSL. These are all things that matter a great deal to airspace users; however, contracts for TANS exist between NSL and airports.

101. The CAA's apparent acceptance of NSL's pessimistic forecasts for **ATFM delays** is worrying; not a single UK airport is proposing an improvement in performance. At LHR in particular, a disappointing RP2 performance (1.95 over 2014-7) is compounded by an RP3 forecast falling to 2.0. That the CAA has set a target at LHR of 1.95 is little relief for

airspace users and is no incentive for NSL to improve its performance; indeed, in three of the four years of RP2, this target was exceeded.

102. As something of an aside, the CAA shows that the increasing number of delays is largely down to **weather**, but provides no evidence that the UK weather worsened over the period in question. This begs a question as to causation; how it is attributed; and whether NSL is ‘playing the weather card’, to avoid adverse KPIs.

Oceanic

103. It is interesting to note that whilst the CAA says that it regulates *“… the maximum charge that NERL can levy on users for its Oceanic service by conditions in the NERL licence…”*, none of those appears to be a risk-sharing mechanism. In 2017, traffic had manifest 16.2% above forecast; however, rather than adjust DUCs, NSL was allowed to earn a 21.63% return on the Oceanic RAB. This is entirely inconsistent with the approach adopted for en-route and claimed by the CAA for Oceanic. (The CAA subsequently suggests that such a risk-sharing mechanism might be appropriate and so we would encourage further investigation of this issue.)

104. Neither NATS nor the CAA has been able to satisfy airspace users that the benefits of proposed **ADS-B services**, to be provided by Aireon, outweigh the costs. It is little wonder that airspace users are deeply suspicious of NSL’s motives; more so, since it is a significant shareholder in Aireon – and hence its own monopoly supplier.

105. Aside from safety, the key performance issue is, as the CAA correctly identifies, a potential for fuel saving, coming from improved separation, the removal of speed restrictions, UPRs (from 2023) and lower contingency fuel uplifts. That these cannot be adequately quantified or agreed is a matter of considerable concern.

106. In the final analysis (which must take place), we would equally advocate both the CAA’s ‘top-down’ methodology and NERL’s ‘bottom-up’ approach; the one being used to validate the other. In either case, the CAA is perfectly correct to include the £15m **capital expenditure costs.**

107. We appreciate the CAA’s ‘stress-testing’ of NERL’s **fuel-saving assumptions**, by reducing fuel price estimates; however, note that the nominator of value is the amount (not the price) of fuel saved. We agree with the CAA that the value of savings in fuel uplift must come following feedback from airspace users and recognise that placing a value on **safety enhancements** is extremely difficult.

108. In conclusion, we accept that there would be benefits arising from ADS-B services; just, we cannot say that these would outweigh the costs. The concern is that NERL has

effectively locked itself into a **vertically integrated supply chain** and is being neither transparent nor convincing in its interactions with both customers and the regulator. This is a cause of concern to us – and we would hope it would be also for the CAA.

109. We wholeheartedly agree with the CAA's view that *"NSL's ownership stake in Aireon raises concerns over a **potential conflict of interest**…"* and appreciate the challenge it has made regarding financial/people/knowledge ring-fencing. We particularly note that stating that *"there is no scope for higher individual pricing for NERL data services compared to other Aireon customers"* and demonstrating it are different things.

110. We agree that NATS should certify a fully ADS-B based Oceanic service, before any cost recovery is allowed, but would urge the CAA to strengthen/clarify its position on costs and benefits. Not only do airspace users require an *"improved service"* they require a service improved to an extent that justifies the cost. The CAA makes reference to this point, when it proposes a review that would *"be to objectively explore whether the benefits have exceeded the costs and are expected to do so into the future."*

111. Self-certification by NATS of the operability of an ADS-B-surveiled oceanic environment alone is insufficient delivery of NERL's vision for the Shanwick operation. It is important that the CAA also links any payment for ADS-B to on-time operational implementation of NERL-lauded deliverables; such as the truncation (ahead of eventual dismantling) of the OTS, introduction of UPRs, introduction of the stated reduced separation standards, an ability to flight plan using variable Mach and level changes, and the improvement to 90% clearance to last requested trajectory across the Atlantic.

112. Turning to **traffic forecasts**, for reasons previously set out, we support the CAA's consistent use of STATFOR data – but are nevertheless unclear as to why there should be such a gap between NATS/STATFOR forecasts and EFFG34. If it is due to the former omitting flights not destined for Europe, then they should be adjusted upward, to compensate for the omission – and we would expect the CAA to take a view on this. As things stand, forecast growth in RP3 is only 60% of that observed in RP2 – and this cannot be right.

113. In terms of **operating costs**, we are broadly content with the CAA's review of staff costs, non-staff costs and ADS-B data costs. We have no additional comments to make on **pension costs** to these made above and agree with the CAA's approach in the area.

114. We note that that NERL provided *"… limited justification…"* for £15m of **capital expenditure** on new systems to manage ADS-B. A regulator should require full justification – and where this is not forthcoming, should consider disallowing the cost, or at least making an objective and independent assessment. The CAA may wish to consider that acceptance by NERL of a modest 5% reduction might signal contentment.

115. As a point of principle, when a regulator applies **inflation** to a RAB, then it indexes not only non-depreciating assets (such as land), but doubly rewards where there is a regulated rate of return, incorporating an inflation element in the costs of debt and of equity. The CAA must be careful to avoid this.

116. We agree with the CAA's assessment that *"NERL [sic] is financed on a company-wide basis"* and our previous comments about WACC are equally applicable to all parts of NATS' business. Understanding the European context, we are supportive of the CAA's approach to the **profiling of charges**.

117. We agree to differential charging for **Tango routes** and other Oceanic routes being on the basis of 'cost of provision'.