NERL response to CAA consultation CAP 2119

15 April 2021

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Summary

On the **main updates**[1] to the CAA's broad approach since its December consultation[2], we support **January 2023** being the proposed start date of the:

- new price control and
- recovery of deferred revenue.

We agree that this start date means that **2022** should be captured by the CAA's **cost reconciliation** exercise, in addition to 2020 and 2021.

In relation to the **incentive arrangements** in place for NERL, we believe that it would be appropriate for these to be suspended for the period 2020-22. These incentives are intended to remunerate NERL's efforts, whereas the outcomes in 2020-22 will be mainly driven by the traffic fluctuations associated with Covid-19.

With regard to **prices** for the next price control, we support the CAA's intended approach of assessing users' interests in light of the outcomes which our plan will deliver, in terms of capacity, service, resilience, cost efficiency, and the development of our capabilities to meet future requirements. **Affordability** in the near term is one factor, but not an over-riding one. A simple 'no real terms increase' metric is an unrealistic target, given the importance of traffic in determining the unit price, which is so difficult to predict at the current time, the significantly fixed nature of NERL's costs, Licence obligations and the recovery of significant deferred revenues.

With regard to **financeability**, we support the CAA's intention to use **conventional regulatory levers** (such as deferring recovery of revenue) to lower charges in the near term and assist the affordability of our services to users during the recovery period following the pandemic. Our commitment to supporting users is demonstrated by this support for revising the current Traffic Risk Sharing mechanism in our Licence. The financing of this revision represents a very significant contribution from shareholders (requiring future dividend restraint in addition to that which has taken place so far).

With regard to the **timetable** for the next price control review, we request that the CAA considers the following changes:

- Carrying out its review of NERL's business plan in seven months (instead of the proposed ten months), which would allow NERL to submit its business plan at the end of March 2022. This will enable better capture of information from the summer 2021 season as well as facilitating more effective user engagement at a critical time for aviation recovery; and

- Carrying out its cost reconciliation exercise in 2022 (instead of both 2021 and 2022), thus optimising the efficiency of this process for all stakeholders.

[1] CAA 2021, *Economic regulation of NATS (En Route) plc: Update on approach to the next price control review* (CAP2119).
[2] CAA 2020, *Economic regulation of NATS En Route plc: Consultation on the approach to the next price control review* (CAP1994).

1. Regulatory policy for the next price control

1 This chapter responds to the key points raised in Chapter 1 and 2 of the CAA's update document.

1.1. Start date

2 We agree with the CAA's proposal to commence the next price control period in January 2023. This has significant advantages over the alternative of starting the next price control in January 2022, which is now no longer a practical possibility given the time that has elapsed. Nonetheless, a January 2023 start date still creates a tight timetable for the overall process. For it to be successful, all stakeholders will need to strictly adhere to the CAA timetable. We strongly believe that some rebalancing of the time allowed for NERL and customers processes compared to the CAA's review is likely to benefit users and lead to better outcomes for the aviation sector in general.

3 We agree with the CAA that a January 2023 start date provides a reasonable balance between the interests of users, in maintaining charges at the level set by the CMA determination for 2022, and the financing needs of NERL. An earlier start date would bring forward the point at which charges would face upward pressure, given the likely lower levels of traffic still prevailing in 2022. The 2023 start date will mean NERL delaying its recovery of revenue and building up a greater balance that will need to be recovered in future years. NERL expects to have the financial capacity to do so, and on that basis confirms that we do not consider the application of 2022 unit charges based on the CMA determination and a price control reset in 2023 would create material additional issues for our financeability. This additional year of revenue deferral represents significant extra financial support from NERL's shareholders, given the associated impact on future dividends, in addition to the dividend restraint so far.

1.2. Duration

4 We agree with the CAA's proposal for the next price control period to last five years. This will provide some stability for NERL to concentrate on supporting users in the period of traffic recovery, including by progressing investment in airspace modernisation and new air traffic control systems which will be vital to sustain future growth in, and increased fuel efficiency of, flights as well as meeting our Licence obligations. A five year control period is far more preferable to the alternative of a shorter term interim price reset, followed by full length review, which would risk creating inefficient breaks in investment and service planning and would consume scarce management resource of the CAA, NERL and airlines (during a recovery period when they might be able to least afford it).

1.3. Traffic Risk Sharing

5 We support the CAA's proposal to modify the licence later this year to change the terms of the existing Traffic Risk Sharing (TRS) mechanism, with the aim of deferring the automatic recovery of 2020 revenue shortfalls in 2022. We agree with the proposal that the recovery period for 2020 and 2021 TRS revenues should begin in 2023, and then be spread over a five-year period, in line with current European Commission proposals for other European ANSPs. In line with existing policy on the evolution of the Regulatory Asset Base (RAB), deferred TRS revenues should accrue NERL's allowed cost of capital on an annual basis. In addition, given the extended period of seven years

between 2020 and the final year of TRS repayment, the deferred TRS revenues should also be updated for inflation annually. This change would bring the treatment of deferred TRS revenues into line with the normal treatment of items in the RAB, such as annual variations in capital expenditure from the amounts originally planned for.

6 The choice of repayment period should be informed by a financeability assessment of NERL's capacity to defer recovery of these revenues. In order to minimise the financing costs to users, we will need the CAA to confirm the recovery period for the revised traffic risk sharing mechanism as part of their June 2021 update. This will allow appropriate long-term funding mechanisms relating to this deferral to be put in place in early 2022.

7 The CAA notes[3] that the licence modifications necessary to effect changes to the TRS mechanism may also include other relevant and/or consequential changes, such as the treatment of service quality incentives. We consider that, given the extraordinary fall in traffic over 2020 and 2021, and potential traffic fluctuations between now and the end of 2022, the current service quality targets for delay and 3Di for the period 2020-22 are no longer appropriate. In particular, we consider that it would not be appropriate or fair for NERL to seek to recover from users these bonuses given that the achievement of the targets is materially easier while traffic remains well below levels projected when determining the RP3 settlement. It would be a reward for factors beyond our control rather than NERL's efforts. For symmetry and fairness, NERL should also not to be subject to penalties if traffic returns much quicker than expected over this period. We remain committed to delivering a safe, efficient, and effective service for users, and will continue to plan to deliver delay and flight efficiency outcomes within the parameters set for RP3 as well as our Licence obligations. In this regard, the Palamon Final Decision will be a key consideration for our planning for the next price control period.

1.4. Cost reconciliation

8 We agree that in calculating the level of revenue to be recovered under the revised TRS mechanism, the CAA should base this upon its assessment of efficient costs incurred in 2020, 2021 and 2022. We also agree that the CAA should adopt a proportionate approach to this assessment, focusing on the most important cost items and those which have shown the greatest variance from the CMA's determination.

9 As highlighted in our response to the CAA's December Consultation on its approach to resetting our price control, we took early and decisive management action to secure continuity of our operations, preserve liquidity and minimise operating and capital costs. In 2020, we delivered around £130m cash savings compared to our pre-pandemic plan, driven by various management actions including pausing and then re-planning our capital investment programme (around £50m), eliminating discretionary spend given lower activity levels more generally (around £30m), freezing recruitment/releasing contractors (around £30m) and drawing on the Government furlough scheme (around £25m). In 2021 we expect to deliver a further £155m cash savings relative to our pre-pandemic plan through related actions. We also took steps to reduce our headcount through a voluntary redundancy programme, to generate further ongoing cost savings.

10 We consulted with customers promptly when we suspended all but essential elements of our capital investment programme in Spring 2020 to preserve liquidity. We consulted with them again

[3] CAA, 2021, CAP 2119, paragraph 3.17

and sought their support for restarting the capital programme on a re-phased and segmentally controlled basis in Autumn 2020, after securing extra bank funding during Summer 2020. This consultation was supported by "deep dive" workshops to provide airlines with greater detail on our airspace and technology workstreams to facilitate their feedback. A further consultation was then held in December to bring together several options for NERL's investment programme based on this airline engagement, including the potential outcomes of each option and the associated timescales for delivery.

11 We reiterate that, in conducting this cost reconciliation, the CAA should recognise that we have taken timely decisions in the near term, in light of the best available information at that point, including, where relevant, feedback from customers, and against a background of unprecedented extreme uncertainty about future traffic demand, in both the short and long term. We suggest that the CAA conduct its reconciliation review of 2020, 2021 and 2022 to recognise the difficulty of making operational and financial decisions during this period, rather than versus an artificial *ex post* benchmark derived with the benefit of hindsight.

1.5. Future regulatory framework

12 We agree with the CAA's stated intention to develop an approach to a new price control which results in affordable charges for users and supports financeability, subject to our comments below on how users' interests are assessed. As we discussed in our response to CAP 1994, we would encourage the CAA to assess "affordability" of air traffic control charges in the wider context of users' overall costs, and in turn to balance these concerns with wider user interests in NERL delivering a resilient service, including meeting the developing needs for service and future capacity. The CAA has noted in its publications the importance of cost fluctuations on marginal routes for airlines. In this regard, NERL has to date been consistently more cost competitive compared with its major European ANSP comparators, both in terms of charge per flight hour (financial cost effectiveness) and when factoring in the additional cost of ATFM delays attributable to each ANSP (economic cost effectiveness)[4]. Focusing on en route services only, NERL is 2nd among the top 5 for cost effectiveness and is 18% better than the mean.

13 With regard to assessing the appropriate level of charges, we support the CAA's move away from any simple definition of affordability such as 'no real increase in charges". In our view, any assessment of whether the proposed level of charges reasonably meets users' interests over the next price control period can only be made in light of a broader assessment of the outcomes which our plan will deliver, in terms of capacity, service, resilience, cost efficiency, and the development of our capabilities to meet future requirements.

14 We agree with the CAA's assessment that prices could increase in real terms, to pay for the efficient delivery of service levels and investment mandated by users. In our view, notwithstanding early action by NERL to cut costs, starting in 2020, and a continued focus on efficiency in our planning for the next price control, it is unrealistic to expect charges to remain close to unchanged in real terms over the next period, compared with the pre-pandemic level in 2019. This price challenge for ANSPs is driven by:

[4] Eurocontrol 2021, ACE 2019 Benchmarking Report with 2020-2024 outlook, 2nd draft March 2021.

- the protracted and uncertain pace of traffic recovery currently forecast, with 2019 levels unlikely to be reached for a number of years (due to the number of chargeable service units being a key driver of the calculated price);
- the need to recover in charges over five years from 2023 the Traffic Risk Sharing revenue shortfalls from 2020-22, where 2020 alone indicates deferred recovery of c. £450m of TRS revenues over the next control period, which alone would increase prices by c. 15% (all other things being equal);
- the high level of fixed costs required for NERL to deliver a universally safe and resilient service, regardless of the level of traffic which materialises, which the CAA's Final Decision for its Palamon investigation emphasises is a requirement of our Licence[5]; and
- the difficulty of scaling operational staff numbers to demand during the recovery period, given the long lead times, measured in several years, to increase the number of qualified operational staff available for front line service, and thus the need to retain surplus staff while traffic comes back.

15 We support the CAA's intention to use conventional regulatory levers to achieve charges lower in the near term and assist in affordability of our services to airlines during the recovery period following the pandemic. We have already demonstrated our support for affordability to users, including revising the Traffic Risk Sharing mechanism in our current Licence to defer the recovery of revenue due in 2022 to an extended period from 2023 to 2027. Such action represents a significant contribution of c.£450m of extra liquidity into the aviation market, for that single year alone. This is in addition to the significant contribution NERL shareholders have already made to support users' interests, through both the use of historically earned dividend-paying capacity to take on additional pandemic-related borrowing and in the form of dividends not declared despite the relatively low level of equity risk assumed within the current cost of capital assessment.

16 In addition to the balancing of affordability and financeability, the CAA notes that it intends to develop its approach to the next price control in a number of ways:

- to consider how best to deal with traffic volume risks beyond 2022;
- to focus on providing appropriate incentives for efficiency, to aid affordability, while also protecting the quality of service;
- to develop the regulatory framework to support NERL's financeability, its capacity to invest in the longer-term and avoid any undue increases in its cost of capital; and
- to build on the existing arrangements wherever possible and appropriate.

17 In our view, the current regulatory framework has proved itself to be relatively robust to shocks. Investors have felt confident enough to maintain their investment, and even provide new financing to NERL, based on regulatory assurances about the stability and longevity of regulatory model that ensures the recovery of invested capital with appropriate returns for risks borne. Notwithstanding there being no clear rules in place during 2020, 2021 and 2022 for allocating cost and traffic risk, NERL has proceeded actively and without regulatory mandate or prompting with a comprehensive

[5] CAA 2021, *Investigation under s.34 of the Transport Act 2000: Project Palamon – Final Decision* (CAP2100)

cost reduction and liquidity management plan. Together, this highlights the strength of the regulatory framework in relation to traffic risk sharing and pension pass through in particular, which provides NERL's management and its investors with the confidence to take the right decisions at the right time in the interests of users, guided ultimately by NERL's Licence and statutory obligations. This has also been achieved in part through NERL's financial resilience from shareholders historical dividend restraint, which has enabled it to respond positively to proposals to modify the Traffic Risk Sharing mechanism and to offset upward pressure on charges in 2022.

18 At the current time, we do not see an urgent requirement for changes to the regulatory framework for the next price control. Indeed, there is virtue in retaining the current framework, which has only recently been reviewed by the Competition and Markets Authority and found to be fit for purpose. The limited time available in the review could then be focused on considering the substantive content of the business plan for the next price control, and how the capacity, service and price outcomes can best be balanced during this extraordinary period of recovery from the pandemic shock. Attempts to fine tune the regulatory framework could become a distraction and even have unintended consequences for NERL planning and/or investor confidence. Maintaining stability, clarity and predictability in the regulatory framework is valuable to investors, and thereby would deliver benefits to users in the form of capital costs lower than otherwise required.

1.6. Pensions

19 We welcome the CAA's publication of its Regulatory Policy Statement (RPS) on NERL's Defined Benefit pension costs. We also welcome the amendments made to the previous draft RPS, in light of our comments and those of the Trustee, which have served to clarify the objective for NERL and the Trustee to achieve efficient and reasonable pension costs, and to acknowledge that the primary responsibility of the Trustee is to the scheme members.

2. Next price control review timetable

20 This chapter responds to the issues on process and key deliverables discussed in Chapter 3 of the CAA's update document.

2.1. Business planning

21 We consider that there is sufficient time available in the period April 2021 to December 2022 for the CAA to reset the price control for NERL. This will involve NERL constructing a five-year business plan that is less detailed than for previous price control reviews, based on rolling forward sensible assumptions with variations for options based on consultation with its users. This will require all stakeholders to commit to the process, including meeting their respective deadlines. In this context, the consistency and stability of the regulatory framework will be vital for facilitating the faster pace of this price control reset compared to others in the past.

22 The recent nature of the RP3 process and CMA appeal means that the CAA can carry out a proportionate review that is focused in priority areas. As indicated in the table below, there are at least two areas that should not need reviewing, given the recency of previous reviews. The forthcoming review can be focussed on 'moving parts' only.

No review required	CAA review only	CAA consultant review
Cost allocation	Non-reg income	Opex (headcount and evolution)
Capex governance	Staff unit operating costs	Pensions
	Financial model assurance	Capex (ex post assessment)
	WACC (excluding asset beta)	WACC (asset beta only)

23 NERL is open to an innovative approach to the next price control, but that requires all stakeholders (including the CAA and users) to approach things in an alternative way too, reflecting the very different world that we now find ourselves in. We view this as critical given the importance of this plan to support the recovery of the sector. We judge that significant additional value would be achieved if NERL were granted until March 2022 to complete the following tasks rather than the eight-month period between now and the end December 2021:

- develop a five-year plan;
- engage with our customers on the draft plan; and
- respond to the CAA's efficiency scrutiny.

24 If NERL can submit its five-year business plan at the end of March 2022 instead of December 2021, it will have a number of advantages. In particular, the aviation industry will be further down the road to recovery and normality. This will mean additional, important data will be available to NERL and users and more resources will be back in place for better engagement from airlines.

25 In the timetable being proposed by the CAA, NERL will be trying to halve the time it takes for process from 18 months to nine months. The table below highlights that the business-planning and customer consultation elements of this process will be particularly curtailed, when it is self-evident that engagement with airlines during this process will be more difficult to achieve than for previous ones. Airlines are likely to be either re-establishing teams or setting up new ones with members that could be unfamiliar with NERL and/or the CAA, during a critical time for the aviation industry in general. This engagement challenge for airlines will become a difficulty for NERL and the CAA, where NERL wishes to ensure stakeholder buy-in to its plan and the CAA uses customer consultation as an important element of its own scrutiny.

	CAP 2119 proposed timetable implications	Previous price control equivalent timing	CAP 2119 proposed time reduction for NERL activity
Strategy / approach	Late Spring 2021	Now	N/A
Board approval of initial plan / plan elements	September 2021	November 2021	-2 months
Issue plan to customers	October 2021	March 2022	*-3 months*
Consult with customers	October 2021	April-July 2022	*-3 months*
Board approval of final plan	November 2021	September 2022	-1 month
Submission to CAA	December 2021	October 2022	N/A
Total elapsed time	9 Months	18 Months	-9 Months

26 In addition, the important work of engaging with the CAA and its consultants to explain and justify NERL's efficient level of costs retrospectively will need to be undertaken by the same team who will be developing the plan for the next price control and its supporting evidence. Time spent on the former activity would necessarily take away from the latter.

27 We suggest that this problem could be readily resolved by deferring to the first half of 2022 the scrutiny of NERL's efficient costs for the period 2020-22, for the purposes of the Traffic Risk Sharing cost reconciliation review. At this point, the CAA would be able to assess actual costs incurred in 2020 and 2021, and a combination of actual and settled projections of costs for 2022. As such, it is likely to be more efficient to conduct the cost reconciliation review as one exercise then, rather than in two stages (in 2021 and again in 2022) as suggested by the CAA's current timetable. We should be able to engage with the CAA in the second half of 2021 on its approach to the reconciliation review, so that this could be consulted on and settled by end 2021, thereby enabling a prompt start by the CAA consultants on the actual scrutiny of NERL costs in the first part of 2022.

28 We have considered the impact that these changes could have on the CAA's timetable if we are to work together and complete the workstream by the desired timeframe. We note that the CAA justifies the proposed 10 months allocated for its own activities (versus 9 for NERL's business planning and customer consultation) on the grounds that it took 10 months for such regulatory work in the RP3 review (from the receipt of NERL business plan in October 2018 to the issue of CAA final proposals in August 2019). However, we disagree that the CAA could not complete its review in a shorter time period.

29 In particular, the CAA did complete its processes in less time for earlier price control reviews. The CAA highlighted in its consultation document that the new appeals process will mean it needs to

complete its processes for the next price control three months earlier than it did for RP3. However, the previous Single Sky European Sky regime for RP1 and RP2 required the CAA to complete its processes more than six months earlier for DfT scrutiny, DfT submission to the European Commission and European Commission approval. The CAA and the UK government were able to meet these significantly tighter timescales when some National Supervisory Authorities and their Member States did not. For example, at CP3 (or RP1), there were 7 months between submission of NERL business plan in March 2010 and the CAA's formal proposals in October 2010; at RP2, there were similarly 7 months between submission of NERL business plan in October 2013 and the CAA's formal proposals in May 2014. As noted in paragraph 22 above, the recent nature of the CAA's RP3 decision and the CMA appeal should help to speed up the CAA's review.

30 We would encourage the CAA to reconsider its outline timetable and to rebalance the time available towards NERL-led activities which would help usefully inform and develop its business plan as well as allow for essential and meaningful customer consultation during a critical time for the aviation sector in general. With additional time, for example to end of March 2022, we would be able to better deal with current uncertainties by incorporating information from summer 2021 in the autumn traffic forecast which we anticipate STATFOR issuing in November. We would also be able to continue customer engagement through to the end of the year, reflecting more broadly with airlines on the implications for next price control of the pace of recovery and the latest forecasts. We consider that such activity would be likely to lead to a fuller and better evidenced plan that is better understood by airlines and responds to their needs, which is likely to be in everyone's interests.

2.2. Business plan assumptions

31 In previous price control reviews, the CAA has provided extensive guidance to NERL on the factors it considers that we should consider in our planning, as well as a description of how the CAA planned to evaluate the plan. It has also provided guidance on the content of NERL's customer engagement process. We note that the CAA considers that much of the guidance issued for the RP3 review remains appropriate.

32 We will proceed on the basis that all the guidance provided by the CAA in its January 2018 document[6] remains relevant. However, we note below those areas where significant updating of the guidance may be relevant or no change appears necessary, on which we welcome the CAA's feedback in its May update.

Area	NERL proposal
Outcomes and outputs for next price control	
Safety	• Update outcome targets in light of latest traffic forecasts
Capacity	• Recalibrate delay targets in light of latest traffic forecasts • Update approach to service performance at the sector as well as network level, in light of CAA decision and recommendations on Project Palamon, Feb 2021

[6] CAA, Guidance for NERL in preparing its business plan for Reference Period 3 (CAP1625), January 2018

Area	NERL proposal
Resilience	• Update approach to operational resilience at the sector as well as network level, in light of CAA decision and recommendations on Project Palamon, Feb 2021
Environment	• Recalibrate environment target in light of latest traffic forecasts
Noise	• No change, given NERL (relatively) limited impact and greater priority of reducing CO2 emissions as part of the "build back green" agenda
Airspace	• Update to reflect establishment of Airspace Change Organising Group (ACOG), and latest developments regarding plans for Heathrow 3rd runway
Cyber security	• No change to core guidance, cyber-security requirements to take account of evolving capital programme
New technologies	• Drones – increasing focus from NERL from a safety perspective
Incentives	• No change to structure or weighting of financial incentives linked to delivery of service outcomes, apart from consideration of treatment of bonuses achieved during periods when traffic is materially below the forecast level on which the price control was based.
Costs	• No change to core guidance on demonstrating that costs are efficiently scaled to outcomes and outputs, deliver demonstrable value for money, supported by options and cost benefit analysis. Given the limited available time, NERL does not intend to explore "value-enhancing approaches to programme governance, including through proposals for shared governance, and financial incentives".[7]
Capital expenditure	• Guidance superseded by new arrangements introduced in RP3 to incentivise user engagement in the development of capital planning and to incentivise the efficient delivery of projects and programmes
Operating expenditure	• No change to core guidance on demonstrating efficient operating costs, linked to traffic forecasts and other costs drivers
Pensions	• Guidance superseded by new Regulatory Policy statement on the policy principles relating to NERL defined benefit pension scheme costs[8]
Cost of capital	Updated in light of: • latest regulatory determinations in aviation and other regulated sectors, • evidence on the interaction between traffic volume risk, expenditure levels, • the timing and level of recovery of deferred revenues, and • changes in market conditions and any new evidence generally.
Regulatory asset base and regulatory depreciation	• Guidance pertained to the one-off fall in depreciation projected in 2021, so no longer relevant.
Financeability	• No change to guidance

[7] CAP 1625, paragraph 4.7
[8] CAP 2119, Appendix C

Area	NERL proposal
Customer consultation	• General principles for consultation stand. Any update should acknowledge the exceptional circumstances in which this year's customer consultation will take place, both in terms of the magnitude of the economic impact to the UK aviation sector, and the limited time and customer resources available in 2021 to support consultation.

2.3. Cost reconciliation

33 We look forward to engaging with the CAA in the second half of 2021 on its approach to conducting the cost reconciliation exercise for the three years 2020-22, to determine the level of deferred en route revenues which NERL can recover from 2023. We stand by the comments we made in our January 2021 response to the CAA's December 2020 consultation document and which are summarised in Paragraph 9 and 10 above.