easyJet Submission to the CAA in Response to its NATS (En-Route) plc Price Control Review for Control Period 3, 2011-2015 of October 2008

Introduction

The following submission is made on behalf of easyJet Airline Company Limited (easyJet), a wholly owned subsidiary of easyJet plc, a company quoted on the London Stock Exchange. It will broadly follow the structure of the CAA’s consultation and will seek to answer the questions raised therein, as they arise.

All references are to the CAA’s consultation document, unless otherwise specified.

easyJet is the UK largest airline, in terms of ATMs and passengers carried. In its 2008 Annual Report and Accounts it reported operating a fleet of 165 aircraft, flying a total of 380 routes between 100 European and African airports. Over the last 12 months, easyJet has carried 45 million passengers – and as such, it will be significantly affected by the outcome of this consultation and has a consequential and legitimate interest in a fair and equitable conclusion.

Benchmarking the Performance of NERL

Q1. The CAA invites interested parties to comment on the potential usefulness of benchmark analysis to inform the CP3 price control review, and on the CAA’s proposed approach to developing analysis of the available European data on comparative ANSP charge performance.

It is interesting to contrast the comments made by the CAA regarding NATS (En-Route) plc’s performance during CP2, in consecutively stating a ‘preference for incentive based regulation’ and ‘a commitment to ensure that the RAB was remunerated’. easyJet understands the meaning of the former to refer to regulation where the cost pass-through coefficient tends to 0 and outturn prices are based on effective benchmarking, irrespective of a firm’s costs. This appears to contradict the second statement, wherein through remunerating a RAB, the cost pass-through coefficient tends to 1.

It follows that were it to both guarantee the RAB and offer incentives to NATS, the CAA would be setting out an asymmetrical regulatory regime, which on one hand removes the downside risk of investment not being remunerated, whilst at the same time, leaves open the upside potential for increased returns. It is self-evident that such a generous outcome would be unfairly funded by airlines.

We further understand the purpose of benchmarking techniques to be to compare measured performance with established best practice – whether this is within a firm, an industry or the wider economy (the latter being the most high powered) and in this way, to establish appropriate benchmarks for applying incentive regulation. In this context, it is unclear whether any of the industry comparators identified by the CAA are appropriate, or indeed, whether any appropriate comparators exist. For this reason, the Eurocontrol Performance Review Unit should be treated with due caution.

So while the use of benchmarking (and by implication incentive regulation) may be supported in principle and while the information it provides may be useful, it is inappropriate to incorporate this into a RAB-based structure. It is also important to understand from the outset that out-performing a different provider does not equate to any particular level of performance. It is simply a comparison that may or may not yield useful information.

Moreover, the CAA in its consultation document has identified a number of physical characteristics that may serve to make like-for-like comparison difficult.²

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¹ Paragraph 3.3
² Paragraph 4.6
**Approach to CP3 Review**

**Q2.** The CAA invites views on which of the two approaches outlined above would enable the CAA to better fulfil its statutory duties.

**Q3.** Under the customer consultation approach, the CAA invites views on:

- the suggested structure and governance of the customer consultation process;
- the proposed allocation of issues to NERL-airline consultation to CAA scrutiny, respectively;
- the timing and balance of the review between customer consultation and the subsequent CAA consultation on regulatory proposals;
- the nature of the CAA mandate; and
- suggestions as to the procedures for consultation which might be incorporated in such a mandate.

**Q4.** Do respondents have any other suggestions on how the process for the CP3 review might best be structured to meet the CAA’s regulatory requirements, recognising the scope for and constraints on airline users participating in this process?

The CAA’s description of Constructive Engagement (CE) is somewhat confusing, not least ‘In the Heathrow and Gatwick reviews, the CAA introduced a process termed Constructive Engagement…’\(^3\) In fact, CE was introduced concurrently at all four regulated airports, including Stansted, where the CAA had labelled it a failure as early as December 2005. In easyJet’s view, the 2008 regulatory settlement at Gatwick did not reflect the outcomes (such as they were) of CE, while it understands that airlines have a number of serious misgivings at Heathrow.

Our negative experiences of CE have left us unconvinced that a traditional regulator-led process would place any more ‘consultation fatigue’ on airlines than would a consultation process – in fact, the opposite seems to be the case; however, we consider that open dialogue between suppliers and customers can only be positive and indeed, we seek this wherever possible.\(^4\)

Whilst the CAA is ‘yet to conduct a formal ex post evaluation of the conduct of the Heathrow and Gatwick price reviews in general, or the role of Constructive Engagement in particular’, we cannot conceive that these could be considered to have been entirely successful.\(^5\)

Nevertheless, in principle we prefer the customer consultation approach, as outlined by the CAA; however, we hope that it will be possible to achieve significantly better outcomes through CP3 than was the case with CE. We envisage a number of reasons why this might be possible, including (but not limited to) differing levels of operational complexity, informational asymmetry and (to a degree) the incentives bearing on the regulated firm.

So despite our misgivings, we are pleased to see that the CAA has not placed itself in a position where it must rely solely on the outputs of dialogue to inform its regulatory decision and so hopes that this will itself provide an appropriate incentive on NATS. Also, the CAA has identified a number of safeguards for CP3 that were not in place for CE and so for these reasons, we support the customer consultation approach; albeit, with reservations that we hope to see dispelled.

easyJet does not understand the CAA’s statement that ‘[it] will attempt to ensure that NERL is even-handed in its engagement with airlines’.\(^6\) This seems to contradict its

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\(^3\) Paragraph 5.8
\(^4\) Paragraph 5.3
\(^5\) Paragraph 5.10
\(^6\) Paragraph 5.5
position that [it considers] that it would not be conducive to productive discussions between NERL and its airline customers if the CAA were to chair these meetings or to attend them on a regular basis, either as participant or observer.\textsuperscript{7} It is difficult to see how the CAA could ensure a certain type of behaviour of any of the parties, if it does not intend to even observe the interaction.

We also find it surprising that the CAA has taken what amounts to an ‘all or nothing’ position vis-à-vis customer consultation or regulator-led approaches. We consider that the CAA should set out the circumstances in which it would step into the customer consultation process, as a facilitator. This approach could be a short-lived but useful mechanism to get across what may be particularly tricky issues, which could (under the CAA’s proposal) potentially derail what might otherwise be a relatively productive process. (The CAA will recall the successful facilitation by the Competition Commission in the airport and airlines reaching agreement at Stansted in respect of the Q5 CapEx plan – previously a seemingly insurmountable problem.)

In terms of the allocation of issues, we disagree with the CAA’s proposal that the question of OpEx is excluded from the customer consultative approach and instead reserved for CAA analysis.\textsuperscript{8} Without an understanding of and an ability to engage on this very significant cost, airlines will have little idea of the consequences of the issues on which they are being consulted. We therefore consider it essential that OpEx is included in the customer consultation process.

We are pleased to note that the CAA intends to set out from the outset guidelines on behavioural standards and ‘NERL’s responsibilities for the timely provision of accessible information…’\textsuperscript{9} We hope to see these realised – and enforced, if necessary.

The CAA has left itself just half a year (January to July 2010) in which to consult on its regulatory proposals.\textsuperscript{10} Without a clear view of how onerous such consultation might be, we note that this is a considerably shorter time period than was required for the airports review. If it subsequently transpires that the outputs of the consultation process are less than expected or hoped, then this seems an unsuitably short time in which the CAA can recover. It appears that in allowing the consultation process to be unobserved, the CAA risks leaving itself out of time.

Regarding the CAA’s mandate, clearly it retains responsibility for the price control; however, without seeing the specific questions, scope and so forth that will be for NERL-airlines discussion, it is difficult to form a clear view on how appropriate this will be.\textsuperscript{11} Nevertheless, we agree that the CAA has broadly identified the right issues.

It will be important to establish early on the structure of the ‘baseline business plan’.\textsuperscript{12} The CAA will recall the difficulties caused by different interpretations at Stansted during the airports review, in respect of ‘a central business plan’. Airlines (entirely reasonably in our view) expected to see a plan that incorporated costs and benefits, rather than the capital investment plan presented by BAA – and ultimately supported by the CAA.

**Scope of Price Controls**

**Q5. Do respondents agree that Eurocontrol charges need to continue to be controlled by revenue or price condition?**

easyJet is pleased to note the CAA’s unambiguous statement regarding NERL’s dominant market position.\textsuperscript{13}

\textsuperscript{7} Paragraph 5.35  
\textsuperscript{8} Paragraphs 5.19 & 5.22  
\textsuperscript{9} Paragraph 5.25  
\textsuperscript{10} Paragraphs 5.48 to 5.52  
\textsuperscript{11} Paragraph 5.31  
\textsuperscript{12} Paragraph 5.12  
\textsuperscript{13} Paragraph 6.23
The revenue condition by which Eurocontrol prices are regulated (rather than the unit price) effectively transfers traffic volume risk from NERL to the airlines.\(^\text{14}\) If forecast volume falls, then the unit charges to airlines increase accordingly, maintaining overall revenue to NERL. We consider this to be undesirable, not least as it acts as a multiplier of the effects of wider economic conditions on a single player in the aviation sector – that is, the airlines.

Although these are shown explicitly for Eurocontrol, figures for 2006/7/8 show that traffic volumes have been some way ahead of regulatory assumptions.\(^\text{15}\) This is reflected in the 4.1% over-recovery in Eurocontrol revenues.\(^\text{16}\)

It is therefore difficult to understand why only half the incremental revenue benefit is returned to airlines, when it is NERL that sets the traffic forecast. Clearly such a mechanism lends itself to manipulation, in order to increase unit charges, by under-forecasting – and subsequently retaining half the incremental revenue.

For these reasons, we consider that the CAA should review the charging structure for Eurocontrol, with a view to moving to a price condition. This would have two key effects. First it would protect airlines from the potential for regulatory gaming in respect of traffic forecasts and second, it would protect airlines from the multiplier effects of bearing NERL’s volume risk.

Q6. Do respondents agree with the CAA’s preliminary views on the scope of regulation of the London Approach?

easyJet sees no particular reason to adjust the scope of the London Approach charges and agrees with the CAA that while there may be a minor inconsistency, the costs of bringing Luton and London City onto the existing license may outweigh the benefits. We also note that the revenues NERL receives at these airports are considered within the single till.\(^\text{17}\)

Q7. Do respondents agree that there should be a separate price control for Oceanic services based on a relatively simple and low cost price review process?

easyJet does not use the Oceanic service and consequently has no strong view on this question; however, it agrees with the CAA that the costs of setting a price cap should not be disproportionate.\(^\text{18}\)

Q8. Do respondents agree that there should continue to be no price cap for North Sea Helicopter services but the costs and revenues (excluding the east Shetland Basin) should continue to be taken into account in the charging till for setting the en-route charge condition?

easyJet has an open mind as to whether there should be a price cap for North Sea Helicopter services. On one hand the CAA identifies that the commonality of infrastructure that exists for (say) the MOD contract makes differentiating costs a highly subjective exercise; whereas, this is not the case for North Sea Helicopter services.\(^\text{19}\)

The question then comes down to the relative costs and benefits of setting a price cap. We consider that there is a ‘user-pays principle’ which should be applied to all monopoly infrastructure - and see no arguable difference in this case. There is no reason for other users to cross-subsidise this business, as might be the case if it is

\(^{14}\) Paragraph 6.17  
\(^{15}\) Table 3-1  
\(^{16}\) Paragraph 3.13  
\(^{17}\) Paragraph 6.29  
\(^{18}\) Paragraph 6.31  
\(^{19}\) Paragraphs 6.32 to 6.38
simply included in the charging till; however, without sight of the costs involved, we
cannot take an informed view as to whether this matter should be pursued.

Q9. Do respondents agree that it is appropriate for NERL [to] work as part of the
SESAR Joint Undertaking to be conducted by the regulated business and
recovered through the Eurocontrol charge?

easyJet supports NERL’s involvement in the SESAR project and agrees that there are
benefits which would likely accrue in future from so doing; however, it does not agree
that the approach set out by the CAA is appropriate.

On one hand, working within SESAR is, as the CAA points out, is likely to be beneficial,
the danger being, as the CAA again identifies, is that users might be doubly charged,
should the benefits stemming from SESAR be subject to some future license regime.
The CAA goes on to say that it considers that ‘subject to suitable safeguards… it would
be appropriate… for costs to be recovered through the Eurocontrol charge.’

easyJet does not agree that users should be exposed to the risks of open-ended cost
escalation and given that the potential for this is currently unknown, cannot support this
approach.

Rather it is for NERL to decide whether or not it should invest in SESAR – and should it
be that any such investment delivers benefits, then of course, NERL should be
appropriately rewarded. It is inappropriate however, for airlines to be asked to
underwrite such investment without any idea of the final cost – or indeed, what benefits,
if any, might ensue.

Q10. What are respondents’ views on how the risks of the SJU should be reflected in
the price control?

Notwithstanding its views on these costs not being passed to airlines, without knowing
their nature or extent, it is impossible for easyJet to form a view on whether or not if
they are to be passed to airlines, they should be capitalised.

There are potential arguments for both approaches and the most appropriate very
much depends of the time lag between cost and benefit. If this would be relatively short
and the costs modest, then it would generally be best to treat this as OpEx, recovering
it from benefiting airlines; whereas, if the opposite were true, then capitalisation might
lead to better outcomes.

Q11. Do respondents agree that the CAA’s approach described above represents a
workable approach for the medium term, which is sufficiently flexible to
accommodate currently foreseeable change?

easyJet agrees that the approach set out by the CAA provides the flexibility required by
NERL in dealing with future changes to airspace regulation. What is less clear is the
potential impacts on airlines and so we look forward to working with NERL and the CAA,
in order to better understand what these might be.

Q12. What are respondents’ views on the balance of incentives facing NERL and the
potential risks to users in the development by NERL of new products?

Q13. What are respondents’ views on the regulatory incentives and/or constraints
which might be placed on NERL during CP3 in this respect?

easyJet would consider it a dangerous precedent were NERL to be allowed to ‘lower or
raise the user charge, or increase or decrease the service offered, to incentivise users
to change behaviour…’ 20 It is inappropriate for monopoly suppliers to manipulate their

20 Paragraph 6.77
outputs in this way, in order to deliberately influence the businesses of customers existing in competitive markets – not least, as these business have been shaped by competition that NERL has not experienced.

This is, however, a different question to that of charges differential. easyJet supports the CAA’s position that ‘it is highly unlikely to oppose price differentiation that was cost-based.’ Our view is that in the absence of incentive regulation – or more correctly, in the presence of RAB-based regulation – then all charges should be cost-related.

Regarding the options put forward by NERL for restructuring en-route charges, easyJet notes a number of issues. First, it is unclear whether changing to a ‘unit rate’ approach from the current ‘split tariff’ approach would address the question of cost-relatedness. Calculation indicates that at a unit rate of £11, aircraft over 68 to 69 tonnes MTOW would benefit, whilst those under this weight would lose out from such a change. Therefore, this approach would negatively impact those routes that did not justify aircraft over this size – and airlines operating homogenous fleets potentially of aircraft under this size. This would lead to a number of dis-benefits for passengers.

On the face of it therefore, easyJet prefers an option of incorporating the London approach charges into en-route charges.

easyJet is not in a position to estimate the impact the Olympics may have on NERL’s activities; however, we consider that price implications for 2012 should be not be dealt with through some price smoothing mechanism, as this would require incumbent airlines to effectively cross-subsidise those operating just at the time of the Olympics. The CAA has identified that there would be both costs and benefits from this event and so it will be important to understand the nature of these. In principle, we feel that those airlines driving the additional cost should bear it themselves. There is no reason why UK aviation should underwrite the business of Olympic opportunists.

easyJet considers that if under current regulatory arrangements there were little incentive on NERL to innovate its offerings, then this would stem from the CAA’s preference for RAB-based rather than incentive-type regulation.

Our view, however, is that under the single till NERL is incentivised to innovate, as it is able to benefit from increased non-regulated revenues within a control period. easyJet considers that this is an excellent incentive, particularly in light of the guaranteed returns that RAB-based regulation provides. On the other hand, the distortions that dual-till mechanisms bring are well documented.

Q14. Do respondents have any other views on any scope issues raised in this chapter, or on questions of scope which have not been covered here?

Not at this time.

Interaction between EU Single European Sky II and CP3 Review

Q15. The CAA invites views on its provisional assessment of the potential interaction between UK economic regulation of NERL and the proposed SES II performance regime.

Q16. The CAA invites views on its proposed approach to the scope and conduct of the CP3 review, which seeks to align as far as possible the outcome of the CP3 review with the requirements on the UK which are likely to stem from SES II.

easyJet can see that the incentives the CAA places on NERL for CP3 need to sit within a broader SES II framework that will follow the CP3 review - and may require different and potentially higher standards. We therefore agree that the CAA should include a change control mechanism, should this eventuality arise; however, it will need to be
objectively structured. In any case, it is far from clear that any agreement will be reached by the EC within the timeframe under consideration.

We agree with the principle that there would be advantages to incentivising flight efficiency, as well as delay - and note that the reason this wasn't done at the CP2 review was the difficulty in setting out ‘robust methodology and reliable measurement…’ The CAA suggests that these matters may be resolved by NERL/airline consultation and whilst broadly agreeing with the approach, we remind the CAA of the benefits facilitation may bring.

We note with interest the CAA’s comparison of NERL performance with that of PRC targets and look forward to exploring these further. The CAA sets out four options for its overall strategy, none of which appears to be the best and most obvious solution. We consider that the CAA should ‘develop CP3 in isolation, until SES II is legally binding on the UK’ but ‘allow for a potential price cap reopening and/or adjustment mechanism…’ It seems entirely illogical to either ignore SES II, try to second guess it, try to second guess it and allow for change if it is needed, or adjust the control period to fit in with an as yet unknown timetable, which is our reading of the options put forward by the CAA.

As it points out, the CAA cannot know when the requirements of SES II will become known, so in the meantime, easyJet considers the best course is to pursue the objectives of the UK system, albeit with provision for change if needed.

Regulating NERL’s Financial Arrangements and Setting the Cost of Capital

Q17. The CAA would therefore welcome views on the relative weight that should be attached to the two objectives set out above.

easyJet considers that the two objectives of efficient financing and a robust financial structure are addressed through different mechanisms within the price control; the first through an appropriate regulated cost of capital and the second through appropriate license conditions and/or regulatory incentives. So whilst these are both important, it doesn't appear that they need to be balanced in quite the manner the question seems to suggest.

It is clear that NERL cannot be allowed to fail through poor financing arrangements; however, this should not preclude the CAA from making appropriate decisions regarding the regulated cost of capital. Businesses do not fail for making less profit than their owners would like; rather, they fail from losing too much money – and there is a wide enough gap between the two for the CAA to be able to achieve its objectives on both counts.

Q18. Do respondents agree that the two alternative approaches are as set out above; or are there any other approaches to the regulation of finance?

easyJet does not see any obvious alternatives to appropriate incentives and/or license conditions in ensuring NERL remains appropriately financially structured.

Q19. Do respondents agree that the CAA should pro-actively regulate NERL’s financial arrangements via license conditions?

easyJet does not agree with all the CAA’s arguments as to why NERL is different to airports; however, because of the particular risks associated with a failure of NERL and the potential for an administrator to cease operations (due to a relatively low capital

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22 Paragraph 7.26
23 Ibid
24 Table 7-2
25 Paragraph 7.31
intensity), easyJet agrees with the CAA’s indication that its financial structure should be constrained by license conditions.

Q20. The CAA invites views on what, if any, changes should be made to the existing license regime.

easyJet does not see any obvious need to change the existing licensing regime in terms of NERL’s financing and assumes this is fit for purpose; however, it remains interested in the issue and looks forward to future consultation.

Q21. Do respondents agree that CAPM should form the principle means of estimating the cost of capital?

easyJet agrees that the CAPM model is that standard tool for assessing WACC and so supports the CAA’s ongoing use of this as its primary tool.

Q22. Do respondents agree that the approach to the market equity risk premium, analysis of beta and the non-zero debt beta provide will be relevant considerations in the CP3 review?

As all of the above are constituents of CAPM, it is self-evident that these will require analysis. We don’t understand, however, the CAA’s suggestion that it may use the cost of equity developed by the CC in its review of airport charges at Stansted in the NERL review. The CAA has argued in the past that the cost of equity differs in different situations and indeed in its Q5 review of Heathrow and Gatwick, set these respectively at 7.3% and 7.9% (post-tax, real).\(^{26}\)

It is consequently difficult to see how the CAA could on one hand differentiate between two regulated airports, whilst on the other argue that NERL and Stansted airports should be treated as being the same. The two approaches appear entirely inconsistent.

Q23. Do respondents agree with the CAA’s initial thoughts on the cost of capital, as set out above? What other factors should the CAA take into consideration?

easyJet broadly agrees with the CAA’s initial views on approaching the cost of capital and looks forward to further discussions on this topic.

\(^{26}\) Economic Regulation of Heathrow and Gatwick Airports 2008 -2013 – CAA Decision, Table 10-1