

NERL CP3 price control CAA's May 2010 Consultation Document

Agenda



10.00	Introduction	Harry Bush
10.10	Regulatory context and approach	Rob Toal
10.25	Scrutiny of NERL's cost base (inc pensions)	Rob Toal Graham French
10.50	Service quality (inc flight efficiency)	Mike Goodliffe
11:05	Q&A session	
11.30	<i>Coffee</i>	
11.45	Regulating finance	Rob Cowle
11.55	The cost of capital	Rob Cowle
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13.00	<i>Finish</i>	

Regulatory context and approach

Rob Toal

CAA's duties under section 2 of TA 2000:

Primary duty

- The CAA must exercise its functions under this Chapter so as to **maintain a high standard of safety in the provision of air traffic services;**

Secondary duties

- The CAA must exercise its functions under this Chapter in the manner it thinks best calculated -
 - to **further the interests of** operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them;
 - to **promote efficiency and economy** on the part of licence holders;
 - to secure that licence holders will not find it unduly difficult **to finance activities** authorised by their licences;
 - to **take account of any international obligations** of the United Kingdom notified to the CAA by the Secretary of State (whatever the time or purpose of the notification);
 - to **take account of any guidance on environmental objectives** given to the CAA by the Secretary of State after the coming into force of this section.

Principles of better regulation

- In conducting this review, the CAA has sought to apply the principles of better regulation so as to ensure that:
 - regulation is proportionate by ensuring that the proposals in this document take proper account of the particular circumstances of NERL and its users;
 - the CAA is accountable for its decisions by exposing the reasons underlying its proposals and decisions to public scrutiny;
 - as far as possible decisions reached are consistent with commitments made by the CAA, or else explain why not;
 - regulation is transparent, i.e. clearly understood by NERL and its users. In terms of its own processes, the CAA has continued to adopt an open and effective decision-making process for the review; and
 - regulation is well targeted through the application of direct price control regulation only where it is properly justified and only to the extent warranted.

Single European Sky regime

- The CAA seeking to establish proposals for CP3 compatible with the final SES regime
- The Performance Scheme Implementing Rule formally agreed on 7 May 2010
- First Review Period (RP1) will run from 2012-2014
- CP3 will last for four years so that CP4 can be aligned with second review period (RP2)
- The Charging Regulation is yet to be finalised
- This will impact the following areas of the price control:
 - **the scope of the control particularly with respect to London Approach;**
 - **the structure of the control;**
 - **volume risk sharing arrangements;**
 - **the approach to cost risk sharing; and**
 - **calculation of annual charges from the determined costs**
- These issues will be considered further in CAA July update document

Timetable for review

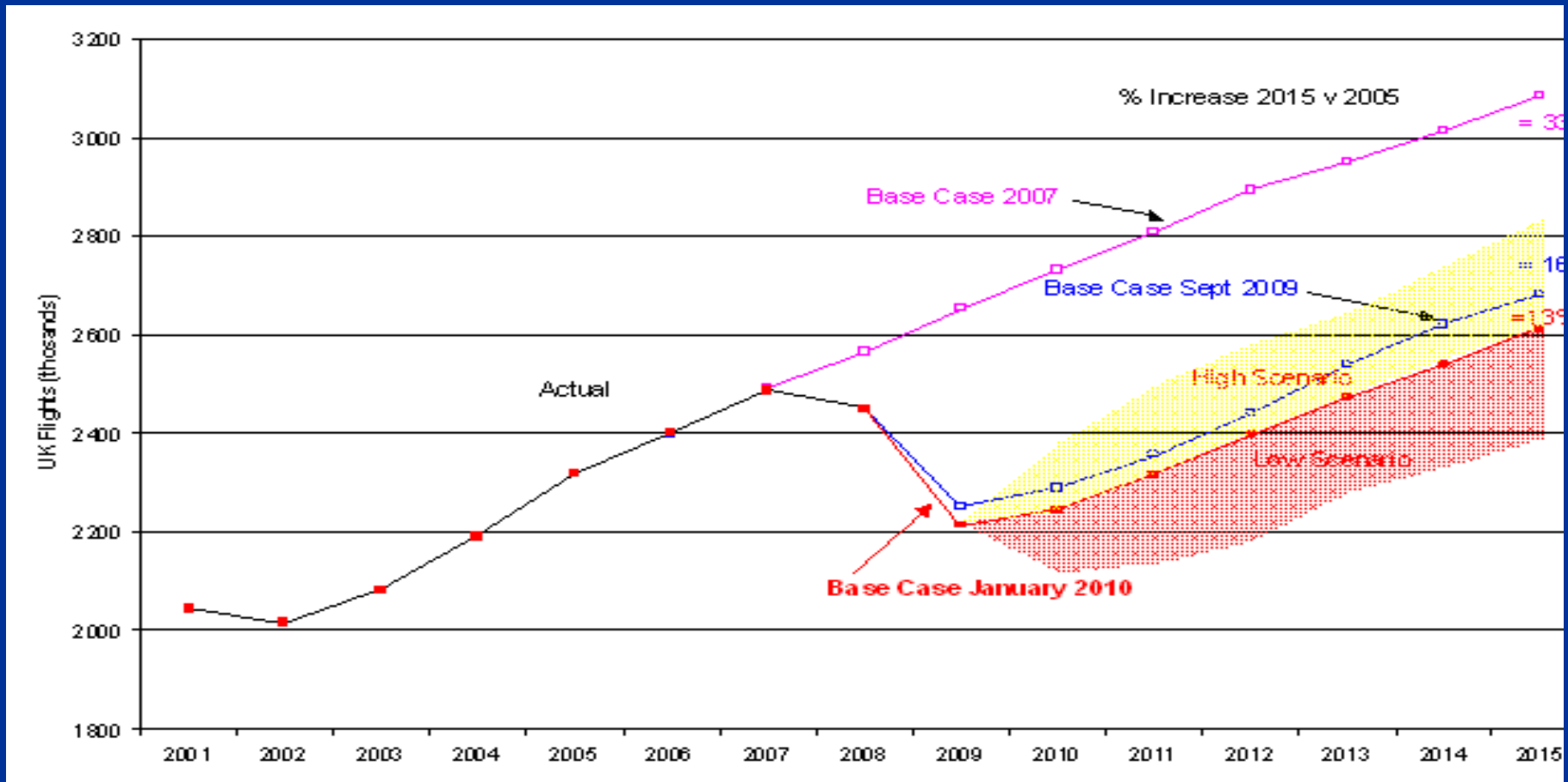


October 2008	CAA initial consultation document
February 2009	CAA policy update
April 2009	NERL baseline plan
April – November 2009	Customer Consultation Working Group meetings
December 2009	NERL updated business plan
February 2010	CAA consultation document
March 2010	NERL final business plan
May 2010	CAA proposals document
29 June 2010	CAA industry seminar on initial proposals
July 2010	CAA update document
30 July	2 nd Flight Efficiency workshop
27 August 2010	Consultation closes
7 September 2010	Oral hearings
Mid October 2010	Publication of price control proposals under Section 11
Mid November 2010	Comment due on Section 11 proposals
December 2010	CAA publishes decision
1 Jan 2011	UKATS control comes into effect
1 April 2011	Oceanic control comes into effect

Scrutiny of NERL's cost base

Rob Toal

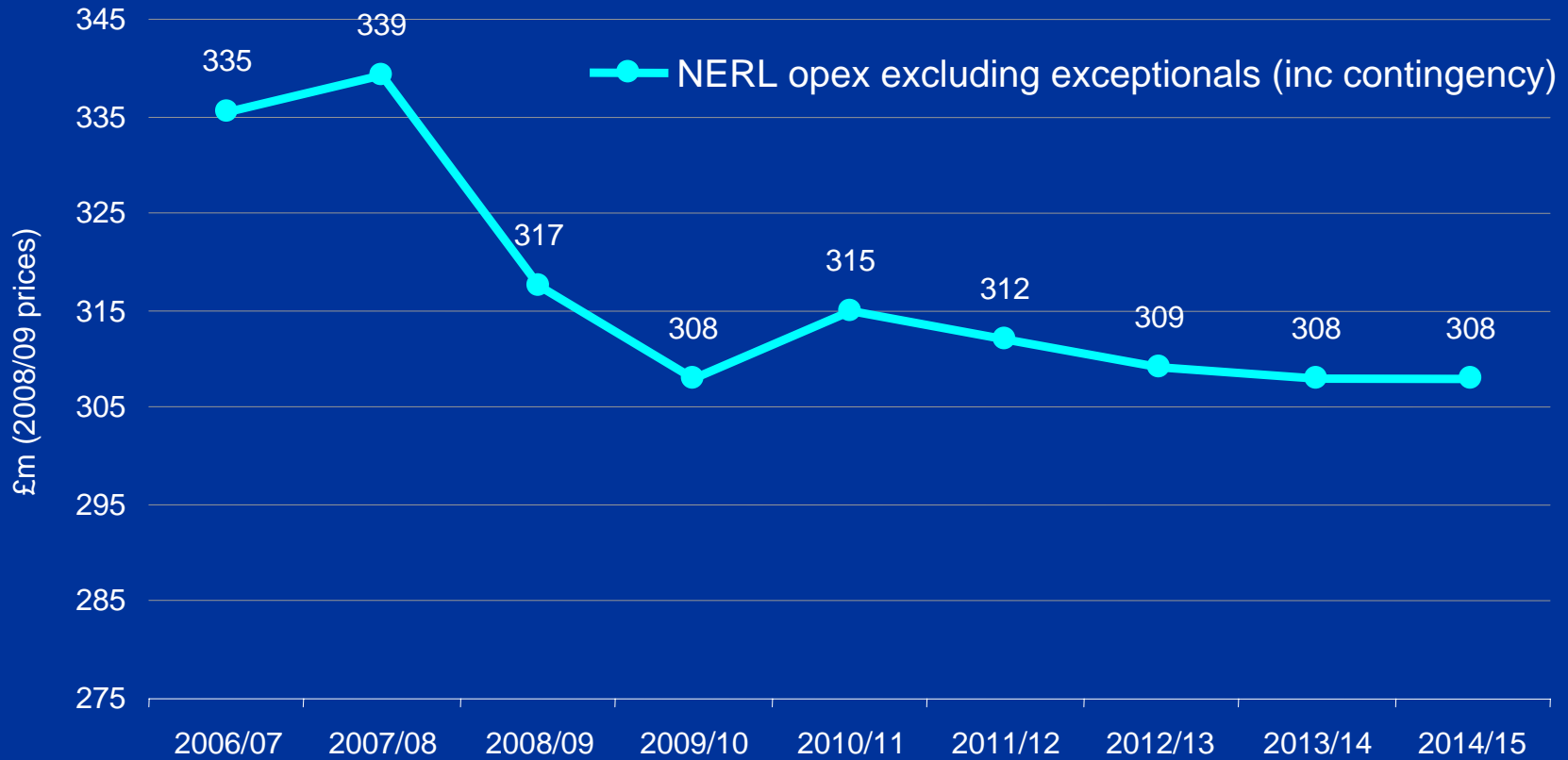
Traffic I



Traffic II

- Forecasts in NERL's March 2010 plan 2.4 per cent below its November plan reflecting:
 - lower traffic in the second half of 2009;
 - updated GDP assumptions;
 - revised load factor assumptions;
- The CAA has compared these with independent forecasts from Eurocontrol and IATA
- NERL's GDP forecasts (provided by Oxford Economics) somewhat optimistic compared to other forecasts, particularly in latter years of CP3: **this suggests a downside risk to the forecast**
- NERL has assumed load factors will continue to increase through 2010 and remain high for the remainder of CP3: **this suggests an upside risk to the forecast**
- Eurocontrol's February 2010 traffic forecast for the UK is more pessimistic than NERL's for the CP3 period: **this suggests a downside risk to the forecast**
- On balance, the risks to the traffic forecast appear to be evenly distributed and therefore the CAA proposes to accept NERL's forecasts

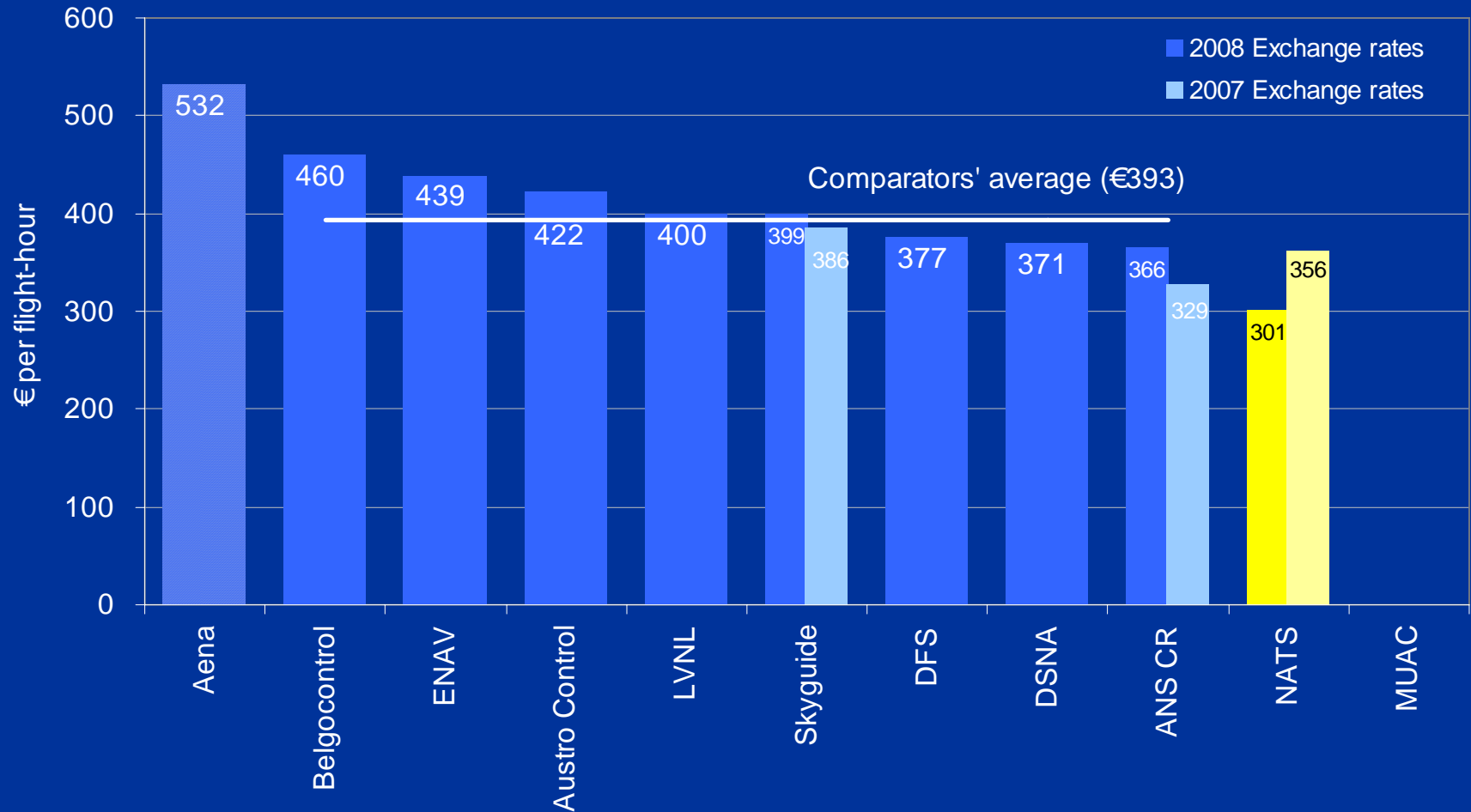
NERL opex projection



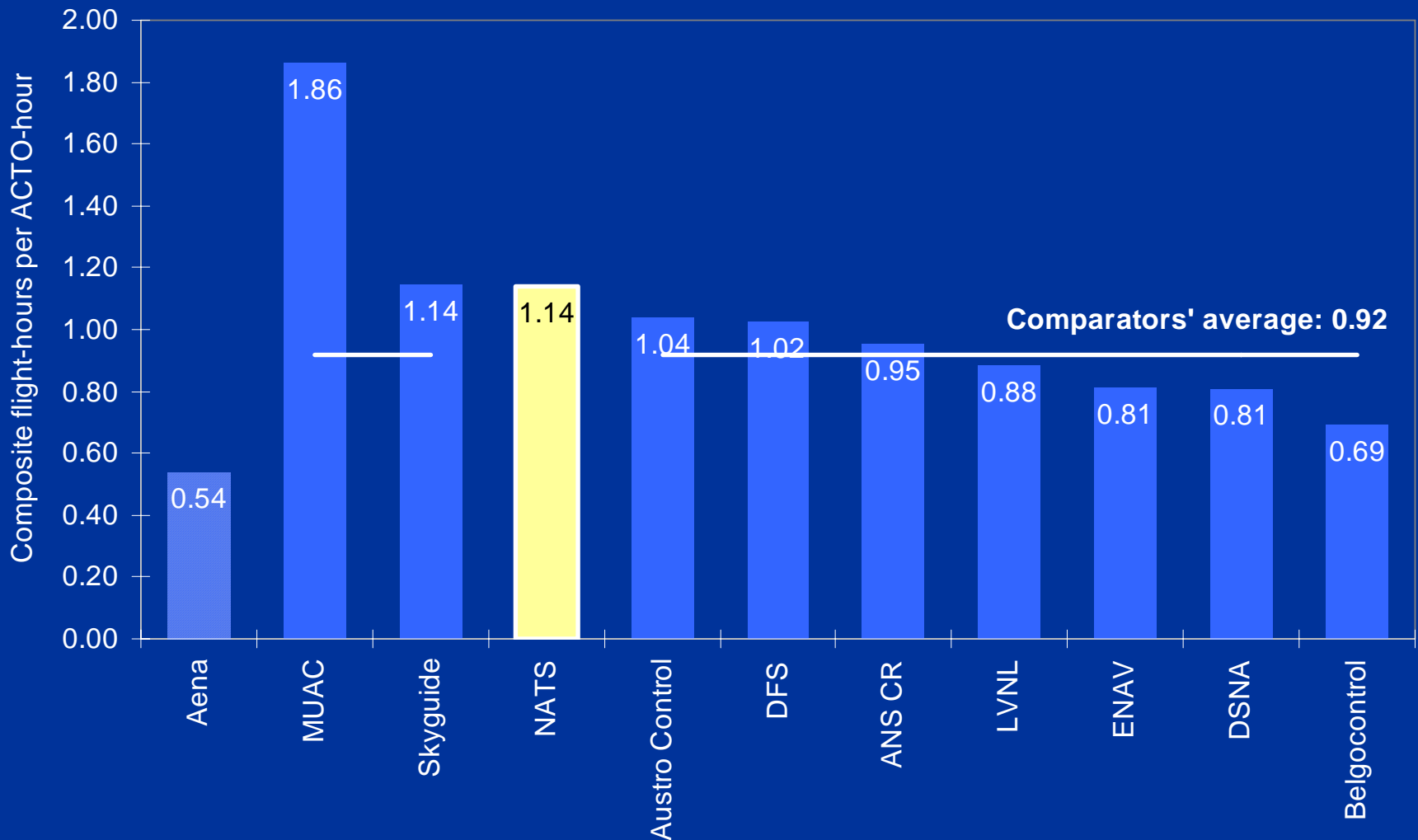
Operating Costs: Benchmarking

- CAA commissioned 3 independent benchmarking studies to consider aspects of NERL's opex cost base:
 - Helios: top down analysis of NERL against other major ANSPs (recently updated for 2008 data)
 - IDS: study of NERL's staff costs (employment costs, benefits, pensions rostering, etc.)
 - LECG: review of back office functions (Finance, IT, Facilities)
- The benchmarking studies indicate that the level of opex in NERL's plan is consistent with a relatively efficient and well managed ANSP
- The latest Helios update indicated that NERL's en-route cost effectiveness performance was now among the best of the European comparators
- The CAA also carried out its own detailed scrutiny of NERL's plan:
 - opex projections had not reduced in line with traffic revisions;
 - savings in 09/10 which yield RIM benefit not shared with customers;
 - issues around NERL's efficiency assumptions and the case for contingency.

Financial cost per flight-hour (en-route) in 2008



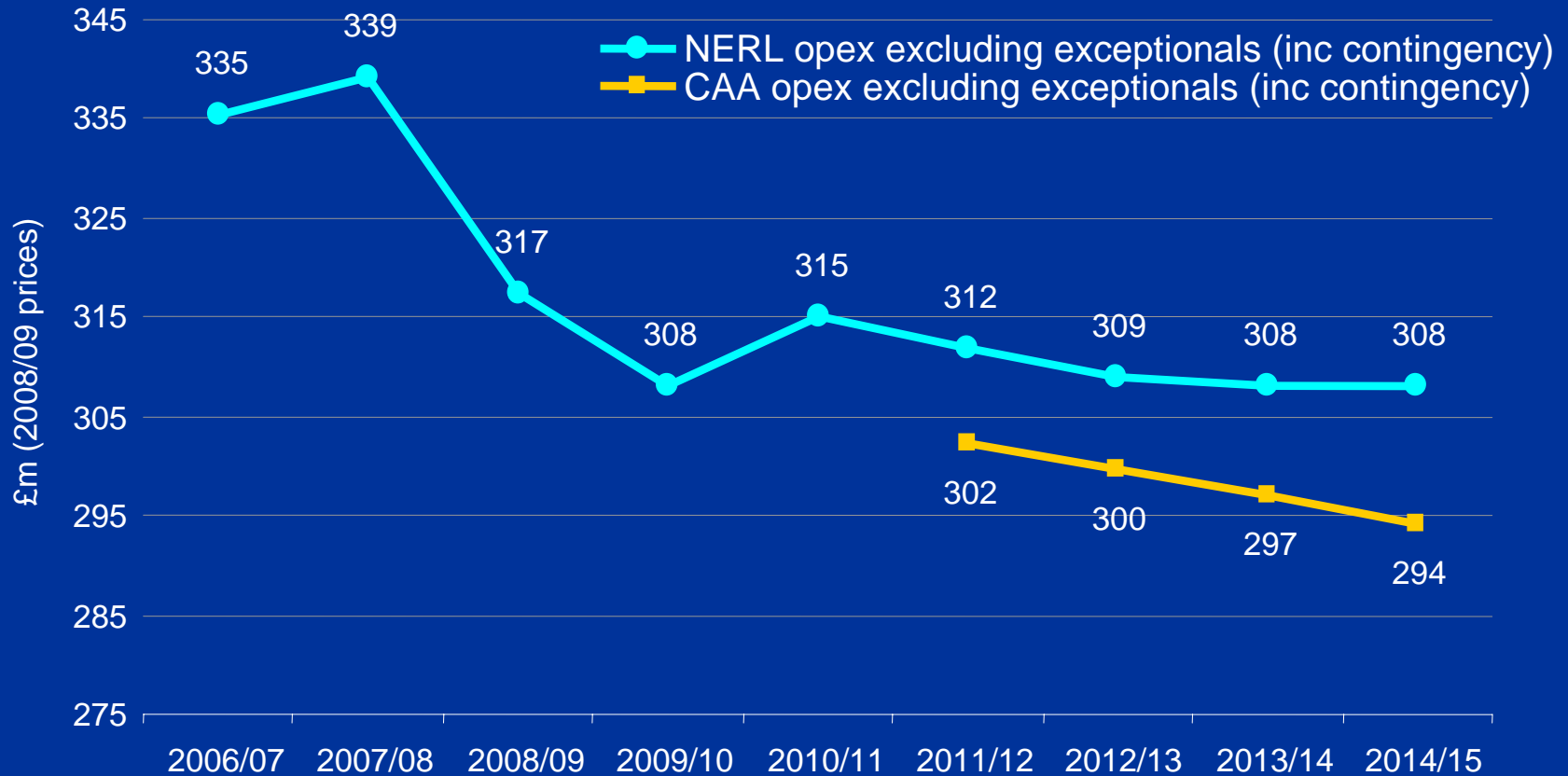
ATCO productivity



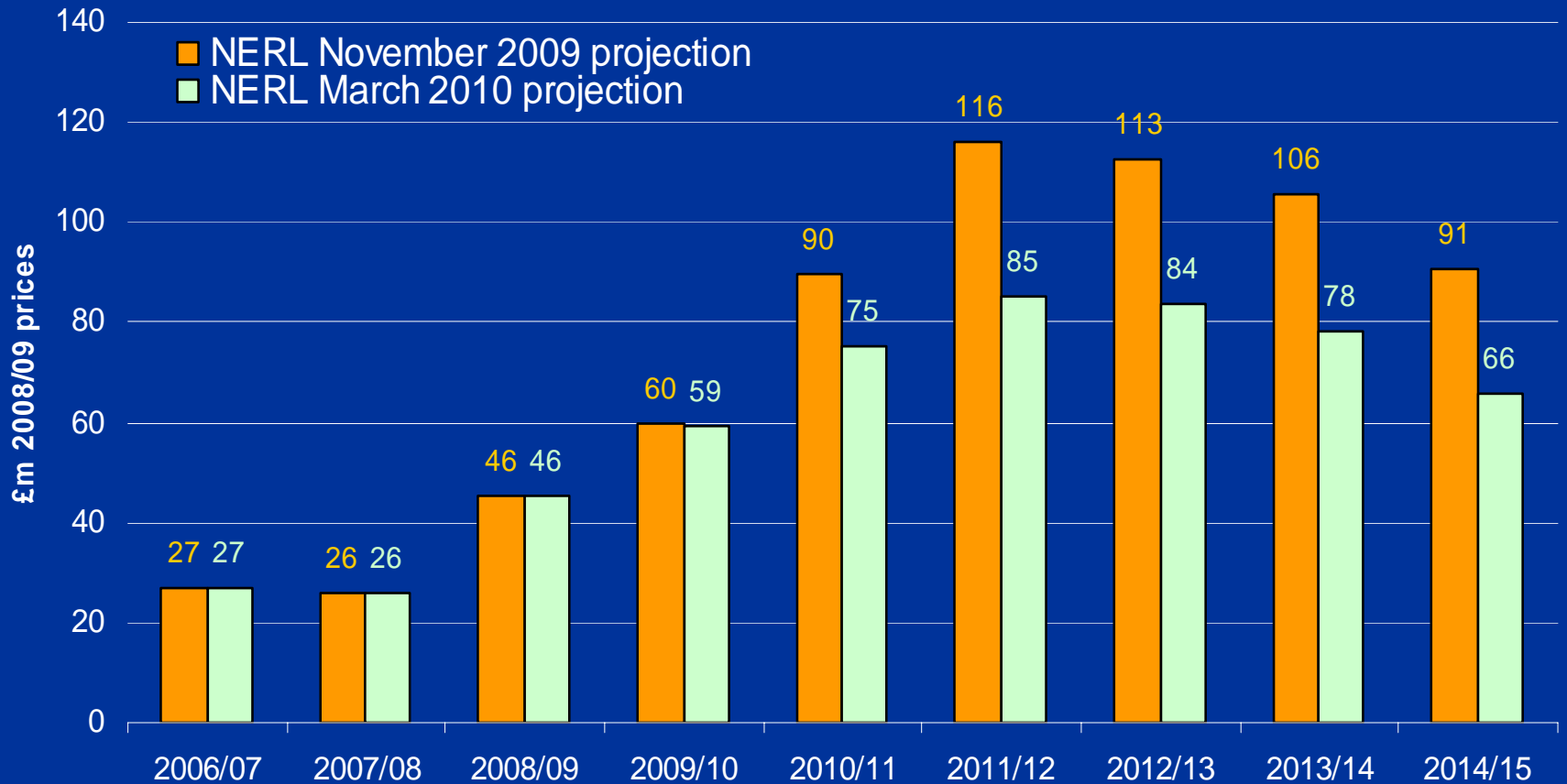
Operating Costs: CAA assessment

- CAA used a three step approach to projecting opex in CP3:
 - **Step 1 – establish baseline from 2009/10 actual costs normalising for any atypical items**
 - **Step 2 – adjust baseline for efficiency (2% p.a.) and volume growth (elasticity assumption of 30% of growth from base year above a threshold of 5% traffic growth)**
 - **Step 3 – allowance for redundancy and relocation (£8m over CP3), 50% of NERL's proposed contingency and other exceptionals**
- Overall, the CAA's opex projection over the four years of CP3 is £39m (3%) lower than NERL's March 2010 Business Plan.
- The CAA's allowance for the CP2 RIM of £27m is £56m lower than NERL's March 2010 projection of £83m

NERL opex projection v CAA opex projection



NERL's pension projections



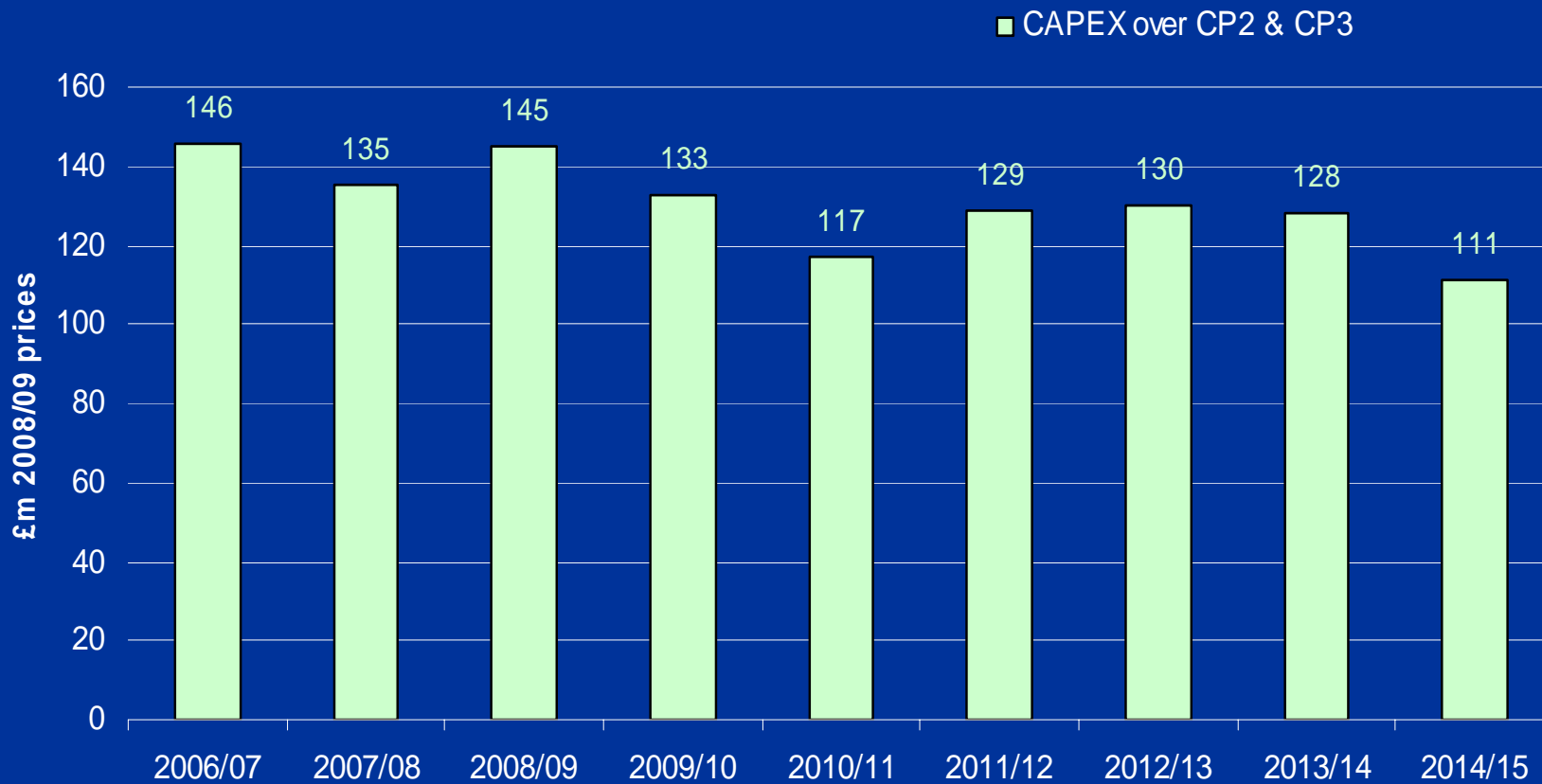
Pensions: assessment

- NERL projection reduced by £112m (4 year CP3) due to a combination of factors:
 - market conditions at 31 December 2009 and assumptions agreed with the Trustees for triennial valuation;
 - improved view on investment returns; and
 - liability assumptions more favourable than previously anticipated.
- NERL has taken steps to reduce the pension costs:
 - DB scheme closed in March 2009
 - Non-incremental increases in pensionable pay capped at RPI+0.5%
 - Salary sacrifice scheme to reduce NI contributions
- CAA asked the Government Actuary's Department (GAD) to consider:
 - NERL's projections
 - Actuarial assumptions
 - Stewardship test
- GAD concluded:
 - assumptions used are within a reasonable range
 - Standard Contribution Rate higher than typical DB scheme reflecting, in part, the level of scheme benefits
 - no cause for CAA to be concerned vis-à-vis the stewardship test

Pensions: proposals

- CAA considers NERL's March 2010 projections to be reasonable and have therefore been included in CAA proposals
- Based on GAD report and submission from trustees, CAA considers NERL meets the stewardship test
- CP2 pass-through arrangements continue in CP3 with end of period true-up
- Pass-through boundary revised to include all employees enrolled in DB scheme

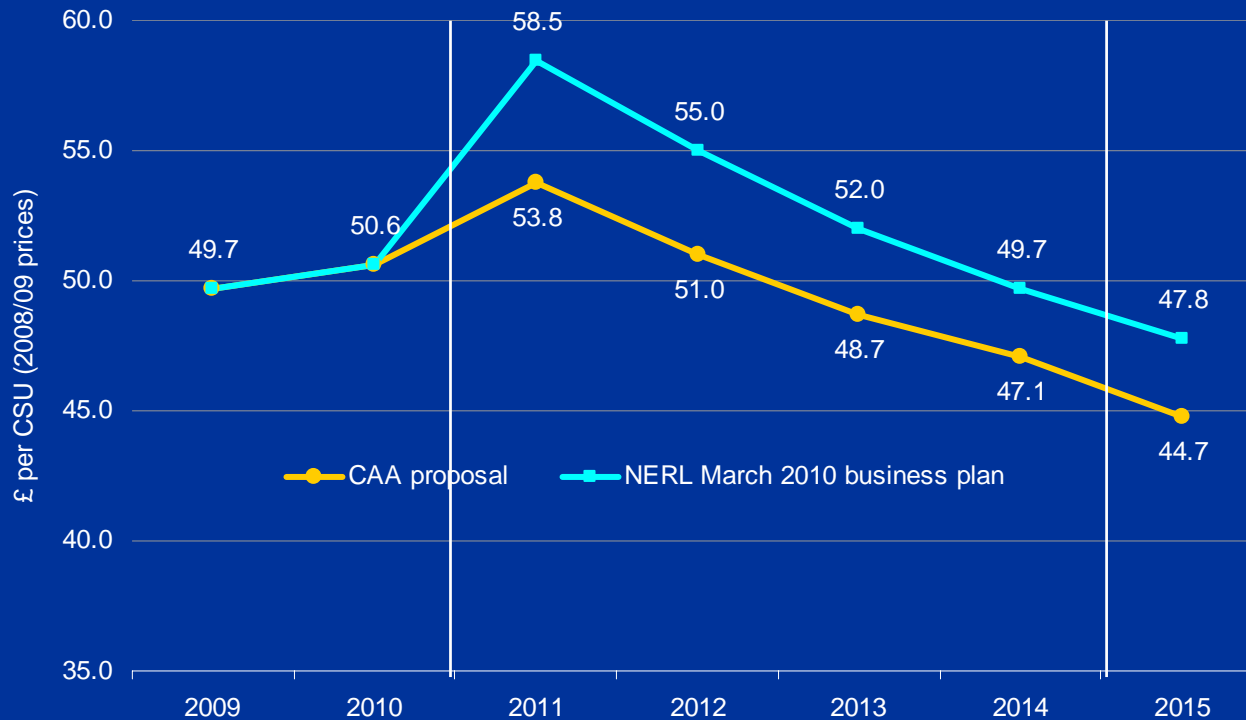
Capital expenditure I



Capital expenditure II

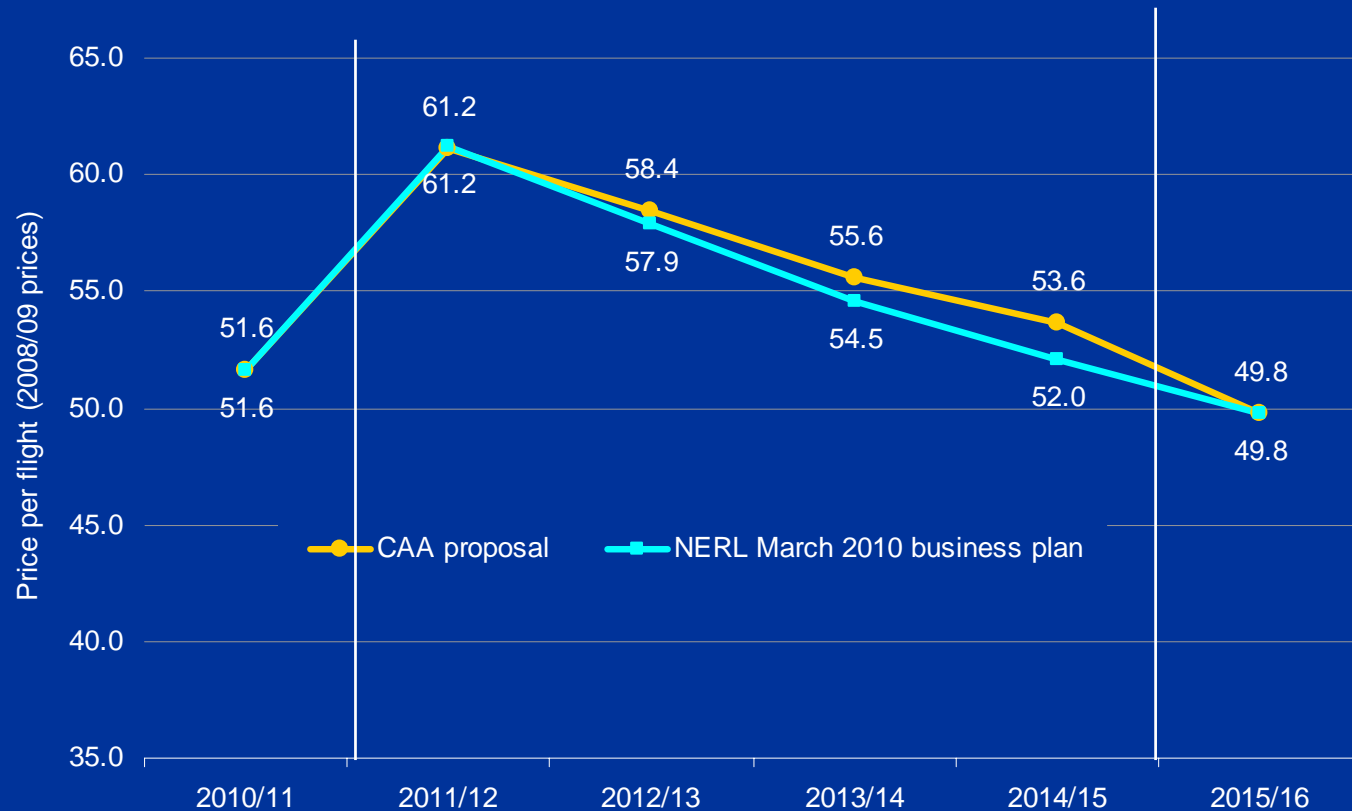
- Total capex in CP3 (4 years) of £498m (08/09 prices) is at a broadly similar level to CP2
- Programme discussed in detail through CCWG
- Some issues identified around level of contingency and scope for reductions for lower traffic but broad agreement around scale and scope of plan
- Logica carried out a detailed review of plan on behalf of CAA
 - concluded scope and sequencing of an integrated plan is reasonable but risk and contingency allowance was low
- Given complexity of plan, CAA proposes to strengthen customer monitoring in CP3 through the SIP

Profile of Eurocontrol prices



- CAA proposal dampens price spike: in 2011
- Spike mainly driven by impact of unwinding of lower than forecast traffic in 2010 and higher pension costs
- CAA's proposal is ~£4.70 (8%) less than NERL's March 10 Business Plan in first year of CP3
- Prices return close to the 2010 level in second year of CP3
- By end of CP3 prices are c.7% below end of CP2

Profile of Oceanic prices



- CAA proposal slightly higher than NERL's plan due to an increase in the RIM from updating for actual opex partly offset by a reduction in the cost of capital
- Spike mainly driven by subsequent impact of lower traffic in 2010/11 than forecast and higher pension costs

Agenda

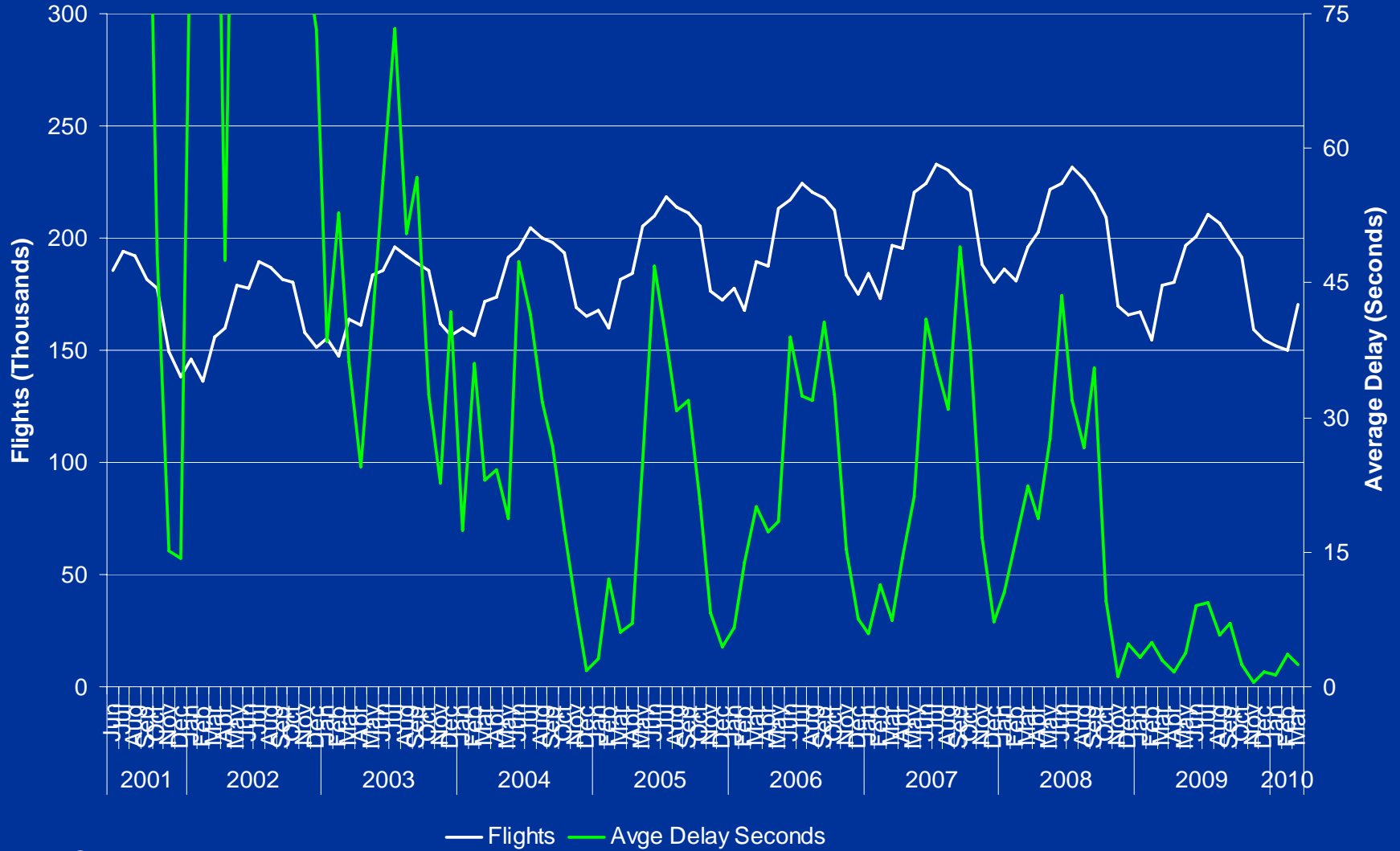


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Service quality

Mike Goodliffe

Trends in service quality performance



Service Quality Proposals Overview

- NERL's service quality delay performance has been improving steadily since 2002
- Service quality discussed extensively within CCWG
- CAA proposes to adopt the three delay metrics (T1, T2, T3) – format largely agreed by CCWG
- Same financial incentives as CP2 max bonus of £11.7m and max penalty of £24m p.a. (all in 2006 prices)
- CAA proposals intended to lock in CP2 improvement in delay performance (but recognising 2009 was not a typical year)

Service Quality Measures

T1 – Average delay per flight

T2 – Impact of individual delays – expressed as an “Impact Score” (placing greater weight on long delays and operationally critical departures in the morning and, to a lesser extent, the evening peak);

T3 – Variability of daily average delays – expressed as a “Daily Excess Delay Score” based on weighted delays exceeding pre-determined thresholds on a daily basis.

Flight Efficiency:

NERL continuing work on metric

Working group 30 July

T1	T2	T3	Flight efficiency
20%	40%	20%	20%

Par Values

Not agreed through CCWG

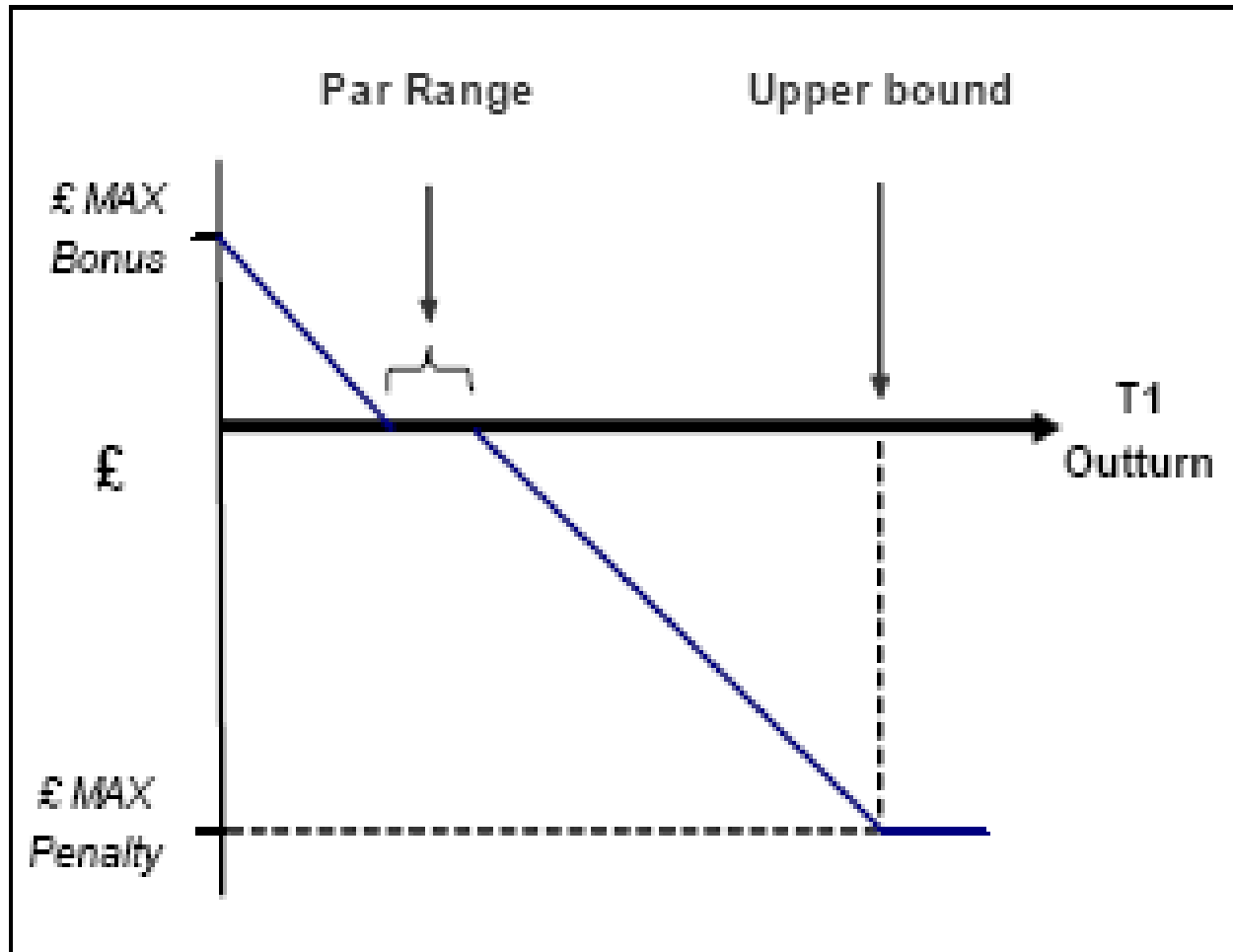
Recent Performance

	2004	2005	2006	2007	2008	2009
T1	25.1	20.8	23.6	23.9	20.6	4.5
T2	72.1	57.3	59.7	60.4	52.1	11.2
T3	1915	1661	857	1432	1391	1.3

2009 an exceptional year – but May proposals adjust Par values down.

	February proposal	May proposal
T1	15-17.5	12.5
T2	45	35
T3	1200	1200

Service Quality Calibrating bonus/penalty



Service Quality Proposals



		T1	T2	T3	Flight efficiency	Total
Share of Bonus/Penalty		20%	40%	20%	20%	
Maximum bonus	(2006 prices)	2,340,000	4,680,000	2,340,000	2,340,000	11,700,000
Maximum Penalty	(2006 prices)	4,800,000	9,600,000	4,800,000	4,800,000	24,000,000
Upper bound	Secs or score	45.00	126.00	4,320.00		
Par Value	Secs or score	12.50	35.00	1,200.00		
Deadband	Secs or score	2.50	5.00	150.00		
Traffic Forecasts 2014	Chargeable Flights	2,541,000	2,541,000	2,541,000		
Rate per score <u>bonus</u>	(2006 prices)	£0.0921	£0.0614	£0.0009		
Rate per score <u>penalty</u>	(2006 prices)	£0.0630	£0.0439	£0.0006		

Source : CAA

In addition

Modulation of targets to reflect actual traffic

Modified approach to cover Olympic period

Money at risk in 2012 split between “Olympic” and “rest of year”

Par values for “Olympic” and “rest of year” modified to reflect seasonal pattern.

Q&A

Coffee

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<i>13.00</i>	<i>Lunch</i>	

Regulating finance

Rob Cowle

Regulating Finance: assessment I



- En-route is essential, monopoly service that by international agreement, the UK Government is obliged to provide
- NERL's failure would have significant and widespread impact on UK and European aviation industry
- Previously commissioned Europe Economics to review and quantify the issues and suggest possible approaches
- Significant risk that current, or new, shareholders could gear up and shift risk to consumers
- Special Administration regime exists but limited credibility that it would be used

Regulating Finance: assessment II



- In February 2010 CAA suggested 4 options, in May focus was given to the 2 that had the most potential:
 - enhanced credit rating; and
 - gearing cap
- Enhanced credit rating had some benefits; but two major drawbacks:
 - circularity; and
 - measures the wrong thing
- Gearing cap gets to the heart of the problem – it avoids inappropriate financial structures with high gearing
- Consistent with gearing used in cost of capital estimate
- Gearing cap meets the CAA's objectives
 - gives the level of resilience required; and
 - users pay for the resilience they receive

Regulating Finance: proposals



- The CAA proposes a gearing cap
- NERL to target gearing of 60% over CP3, incentivised by removing the tax benefit of increasing gearing above 60%
- a gearing cap of 65% in order to give NERL flexibility in day-to-day treasury and trading activities
- above 65% NERL suffers cash lock up and must submit a credible plan to reduce gearing below the cap
- CAA interest in gearing is long term but the precise cap could be amended in CP4

Cost of capital I

- NERL proposed 9% including tax uplift at 35% (although NERL's model suggested it could be as high as 40%)
- CAA commissioned Europe Economics to estimate cost of capital, and Ernst & Young to review tax estimate to be included in the cost of capital

Per cent	CP3 proposals	CP2
Gearing	60	64
Pre tax cost of debt	3.6	3.9
Risk free rate	1.75	2.5
Equity beta (number)	1.35	1.67
Equity risk premium	5.5	4.81
Implied market return	7.25	7.31
Post tax cost of equity	9.2	10.52
Tax rate	30	11
Pre-tax cost of equity	13.1	11.82
'Vanilla' WACC	5.8	6.28
Pre-tax WACC	7.4	6.75

Pending a review of the accounting rate of return, the CAA proposes to use the following values

'Vanilla' WACC	5.9	6.28
Pre-tax WACC	7.5	6.75

Cost of capital II

- CAA proposal of 7.5% is 75 basis points higher than CP2 (6.75%)
 - increase is due to increased tax (depreciation in excess of capital allowances);
 - partially offset by lower cost of debt (market movements); and
 - a lower cost of equity (a reduction in the equity beta, and lower risk free rate being partially offset by an increase in the equity risk premium).
- Gearing assumption of 60% consistent with approach to regulating finance.
- Although cost of capital is important, due to size of RAB it does not have the same proportional impact on NERL's allowed revenues as for some other regulated sectors
- A 25bps increase in the cost of capital would increase the CSU price by c25p

Q&A

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SES II Implications

Process

- Performance implementing Rule adopted by Single Sky Committee on 7 May prior to publication of the May Proposals
- Revised Charging Regulation considered at SSC meeting on 15 June
 - In the event – no vote
 - Possible amendments to a revised draft
 - Decision expected to be taken forward by correspondence within 3 weeks or so (EU issues a revised draft on which to vote – followed by a two week response period) although next meeting is 8/9July.

Issues arising

- Form of CP3 price control
 - Traffic risk sharing
 - NERL 100% risk where traffic is between 98% and 102% of forecast
 - Where traffic is <98% or >102% of forecast – NERL bears 30% of the additional traffic risk (and users 70%)
 - Where traffic <90% or more than 110%, users bear all additional traffic risk
 - Correction n+2 (or earlier over-recoveries only?)
 - Nominal price terms - Revised Charging Regulation (based on expected drafting) would allow correction for inflation before year n+2?
 - Issues around dealing with UK RPI vs SES CPI approach
 - London Approach - Revised Charging Regulation not consistent with a separate London Approach charge being regulated through a common revenue cap with Eurocontrol
- How we set the current and future price controls
 - Cost pass through and true-up mechanisms
 - Bad Debts
 - RAB adjustments
- Impact on cost of capital and financing – CAA continuing to review
- These issues will be considered further in CAA July update document

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Further work and next steps



Timetable

- CAA update document published 2nd half of July
- Flight efficiency workshop 30 July
- Consultation closes 27 August
- Oral hearings 7 September
- Final proposals published mid-October
- Decision published December

Ongoing work

- SES II
- NERL to consider capex consultation arrangements
- CAA and NERL to review Regulatory Accounting Guidelines
- Review developments in economy and aviation industry

Q&A

Comments to kathryn.hodgson@caa.co.uk by **27 August 2010**