Consumers & Markets Group

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Sent by email

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Dear Martin

Summary of CAA RP3 conclusions

Introduction and context

In the light of the representations NERL has made that highlight the advantages of bringing early transparency to the CAA's decisions on the main aspects of NERL's RP3 price control (including allowing for the orderly functioning of the processes in the Transport Act that would allow for a determination by the Competition and Markets Authority (CMA) of these matters if NERL were to reject the CAA's RP3 conclusions), this letter provides a summary of the decisions the CAA Board made on these matters at its last meeting on 17 July 2019.[1] Since transparency is of value to all stakeholders we will be sharing this letter with them and placing a copy on our website.

This proportionate and appropriate step builds on the process that we have previously set out for the RP3 review, and takes due account of the strategic context of progressing airspace modernisation, the interplay between the EU and domestic legal frameworks for the regulation of NERL, and, as noted above, the advantages of allowing for the efficient functioning of the processes that allow for a possible reference to the CMA if NERL was not to accept our decisions as the basis for its RP3 price control arrangements. Exceptionally, we therefore consider there is benefit in setting out the key tenets of our final decisions ahead of their publication in full at the end of August 2019. This will provide an opportunity for NERL to clearly express its view as to whether it will agree to the necessary licence modifications that would implement the CAA's decisions and be held to account for delivery and meet its statutory and licence obligations for safety and quality of service.

This letter summarises the key elements of the CAA Board's decisions and performance targets in respect of NERL. The detailed explanation of our decisions, and the reasons for them, will be

[1] The figures in this letter for our final decisions are undergoing internal and external review. We have not currently identified any significant issues. As appropriate we will reflect any associated updates in our final decision document at the end of August 2019.

set out in our final documents covering NERL's UK and Oceanic licensed activities, to be published at the end of August 2019, alongside the completed EU draft performance plan template that we will provide to the DfT.

Safety is our primary duty and NERL has provided no evidence to suggest that this will be compromised by our decisions.

In taking account of our other duties we have sought to balance the need to further the interests of airspace users (including the importance of NERL delivering the systems to fully support airspace modernisation), with the need to promote efficiency and economy on the part of NERL.

We consider the national strategic objective to modernise UK airspace is fundamental to furthering the interests of airspace users and therefore a key priority for RP3. The systems that users have already funded over the RP2 period and the further systems that NERL plan to implement over the RP3 should allow both for airspace modernisation and significant improvements in NERL's operational performance. We expect NERL to be able to deliver significant operational efficiencies during the latter stages of the RP3 period and for the RP4 period. We will seek to pass on the benefits of these efficiencies to users at the RP4 review.

It is our assessment that our decisions are consistent with our duty that NERL will not find it unduly difficult to finance its activities.

If NERL does not accept our decisions, we expect to make a reference to the CMA for them to investigate and report on whether our decisions for NERL operate against the public interest or may be expected to do so; and if so, could be remedied or prevented by modifying our decisions.

<u>Significant changes since draft proposals</u>

The main changes between our draft proposals and the CAA's decision concern providing NERL with greater resources, focus and accountability to support its leading role in airspace modernisation. In particular:

- we have allowed higher operating costs and moderated our approach to non-regulatory income forecasts, increasing NERL's Determined Costs and the resources it will have available to deliver airspace modernisation;

- we have realigned delay targets to be consistent with the total level of delay implied by the most recent Network Operations Plan and NERL's plans to deliver the new systems necessary for airspace change;

- we have updated environmental targets to account for the latest year-to-date performance in 2019;

- we have also reduced the strength of associated service quality incentives, so that NERL is not discouraged from implementing its programme due to risk of high penalties. Conversely, to make sure that NERL is not unduly rewarded for outperforming more flexible targets we have adopted a near zero bonus for the key EU ATFM delay metric; and

- with this more flexible approach to costs and service quality, we expect NERL to commit to delivering its planned RP3 programme in full. We have therefore introduced a delivery incentive to underpin this expected commitment. *If* NERL does not effectively deliver its programme, we will look to make a reduction to their revenue in RP4, or a downward adjustment to its RP4 regulatory asset base, of up to £36m[2].

The CAA's decisions will provide flexibility for NERL to play its role in the delivery of airspace modernisation, are consistent with the EU cost efficiency target, and provide lower prices over the period, which in real terms will be on average 22% lower in RP3, compared to RP2.

The annex to this letter provides a more comprehensive summary of the CAA Board's decisions on NERL's RP3 price control.

Yours sincerely

Paul Smith
Director, Consumers and Markets Group

[2] Throughout this letter, all financial figures are in £2017 CPI prices.

ANNEX

Safety

Under the EU framework, there is one safety Key Performance Indicator (KPI) in RP3:

> *The minimum level of the effectiveness of safety management (EoSM) to be achieved by air navigation service providers certified to provide air traffic services. This KPI measures the level of implementation of the following safety management objectives: (a) safety policy and objectives; (b) safety risk management; (c) safety assurance; (d) safety promotion; (e) safety culture.*

The UK (and EU) target is that by the end of 2024 NERL must achieve the following levels of EoSM:

> *(a) at least Level C in the safety management objectives 'safety culture', 'safety policy and objectives', 'safety assurance', and 'safety promotion';*
>
> *(b) at least Level D in the safety management objective 'safety risk management'.*

We expect NERL to continue to meet these EU safety targets as a minimum, and support their more challenging internal targets and have adopted our decisions on this basis.

Environment

The EU framework prescribes one environmental KPI for RP3 – the horizontal en route flight efficiency of the actual trajectory, referred to as KEA.

The regulation also allows for the establishment of additional environment KPIs. Since RP1 (2012) the UK has set a target for a domestic environment KPI that encompasses both vertical and horizontal flight (in)efficiency, referred to as 3Di. Our decisions on these targets are summarised in tables 1 and 2.

Table 1: KEA target	2014	RP2					RP3				
		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
UK actual	4.10%	3.93%	4.38%	4.15%	4.08%	n/a	n/a				
NERL proposal					4.08%	4.18%	4.23%	4.25%	4.27%	4.29%	4.30%
EC Reference values					4.08%	n/a	3.53%	3.39%	3.25%	3.25%	3.25%
CAA target					4.08%	*4.05%*	4.06%	4.05%	4.04%	3.88%	3.72%
No financial incentives											

Table 2: 3Di target	RP2					RP3				
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
UK actual	29.5	29.7	29.0	28.6	28.1	n/a				
RP2 target/draft proposals	29.1	28.6	28.3	27.5	27.1	26.8	26.5	26.2	25.9	25.6
CAA target						27.8	27.5	27.3	27.0	26.7
Maximum penalty 0.5% of Determined Costs; maximum bonus 0.5% of Determined Costs										

For the 3Di metric, we have accepted NERL's proposal to take into account the latest performance to date for 2019 and applied the expected efficiency from that estimate rather than using RP2 target values.

Capacity

The EU framework prescribes one en route capacity KPI for RP3 – the average minutes of en route air traffic flow management delay attributable to air navigation services, referred to as C1. This target can be adjusted for certain categories of delay when applying a financial incentive, referred to as C2.

The regulation also allows for the establishment of additional capacity KPIs. We have previously set two additional capacity targets, referred to as C3 and C4, designed to focus on specific elements of delay that are important to users and have retained this approach for RP3, with the targets summarised in tables 3 to 5.

Table 3: C1/C2	RP2					RP3				
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
C1 RP2 target[3]/draft proposals	0.23	0.23	0.23	0.23	0.23	0.23	0.23	0.23	0.23	0.23
C1 NOP reference values						0.34	0.34	0.30	0.26	0.27
C1 CAA target [1]						0.26	0.32	0.32	0.30	0.32
C2 UK actual	0.04	0.21	0.10	0.21	n/a					
C2 RP2 target/draft proposals	0.17	0.18	0.18	0.18	0.18	0.18	0.18	0.18	0.18	0.18
C2 CAA target [2]						0.20	0.25	0.25	0.23	0.25

[1] We have re-profiled C1 target to better reflect expected delays as a result of NERL's planned airspace/technology programmes. The re-profiling is intended to be net-neutral in terms of total number of minutes delay incurred.
[2] C2 is determined as a % of C1 delay.
Maximum penalty 0.25% of Determined Costs; maximum bonus 0.05% of Determined Costs

Table 4: C3	RP2					RP3				
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
C3 UK actual	5.2	25	12.6	17.05	n/a					
C3 RP3 target (modulated)/draft proposals (upper threshold)						22	22	22	22	22
C3 CAA target (upper threshold)						24	30	30	28	30

C3 is an Impact Score, which places greater weight on long delays and delays in the morning and the evening peaks.
It is determined with reference to C2 target.
Maximum penalty 0.75% of Determined Costs; maximum bonus 0.25% of Determined Costs
Total number of exemption days, in respect of Major Changes in Operations, increased from 75 (RP2 level) to 100.

Table 5: C4	RP2					RP3				
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
C4 UK actual	14.2	176.7	0.6	350	n/a					
C4RP2 target/draft proposals	2000	2000	2000	2000	2000	1800	1800	1800	1800	1800
C4 CAA target						1800	1800	1800	1800	1800

C4 measures and incentivises NERL to avoid individual days of particularly severe disruption, which have a significant impact on users.
Maximum penalty 0.25% of Determined Costs
Total number of exemption days, in respect of Major Changes in Operations, increased from 75 (RP2 level) to 100.

[3] C1 target and actual performance were monitored at FAB level in RP2. The RP2 target figures from the table represent the UK-share of the FAB C1 target.

We have increased our C1, and therefore C2 and C3 targets, compared to our draft proposals. We have made C1 consistent with the Network Operations Plan reference values for the UK, but then re-profiled the target for delays. These changes have been designed to ensure the targets take account of the likely impact of the significant airspace and technology transitions in service of airspace modernisation (with the phased introduction of new systems having the potential to lead to a modest and short-term increases in delay).

Financial incentives

Table 6 summarises the service quality (environment and capacity) incentives and compares RP2 with our draft proposals and final conclusions.

Table 6: Financial incentives						
Term	**RP2 (% of revenue)**		**RP3 (% of DC)**		**RP3 (% of DC)**	
			draft proposals		**final conclusions**	
	Max bonus	Max penalty	Max bonus	Max penalty	Max bonus	Max penalty
C2	0.25%	0.25%	0.50%	0.75%	0.05%	0.25%
C3	0.75%	0.50%	1%	1%	0.25%	0.75%
C4	N/A	0.25%	N/A	0.50%	N/A	0.25%
3Di	1%	1%	1%	1%	0.50%	0.50%
Total	**2%**	**2%**	**2.50%**	**3.25%**	**0.8%**	**1.75%**
Value over RP3 (£m)			£72.2	£93.9	£23.9	£52.3

We have reduced the overall strength of the incentives, compared to our draft proposals, to take account of the uncertainties created by airspace modernisation and the advantages of avoiding creating possible windfall gains or losses for NERL. These measures now include a near zero bonus for C2 and lower bonuses and penalties for C3, C4 and 3Di.

Cost efficiency

The EU framework prescribes one en route cost efficiency KPI for RP3 – Determined Unit Cost (DUC). This is calculated by dividing Determined Costs by Total Service Units (TSU). NERL's costs form the main element of the UK DUC.

Our forecasts of TSU rely on an air **traffic forecast** and in our draft proposals we used the STATFOR September 2018 base TSU forecast. For our final decisions we have used the STATFOR's updated February 2019 base TSU forecast.

NERL costs – Table 7 sets out key components of NERL costs and compares NERL's business plan with our draft proposals and final conclusions. The key changes between the two are:

- Operating expenditure (opex) excluding pension costs. We have allowed additional opex of £29m, which aligns with NERL's business plan forecast of opex in the first three years of RP3. Therefore, allowed opex will be £43m lower than the forecasts in NERL's business plan. We have also added £15m over RP3 for the establishment and running of the Airspace Change Organising Group (ACOG) function, which was referenced in NERL's business plan, but not included in forecast opex. We have also increased the Opex Flexibility Fund to £42m, from £35m in our draft proposals. We continue to expect this fund to be utilised, predominantly, to support airspace modernisation.

- Non-regulatory income. We have reduced the difference between our forecast of non-regulatory income and the forecast used by NERL in its business plan, from £49m to £24m, and applied this difference to opex. We also changed our forecasts of non-regulatory income from NERL's MOD contract. These changes will reduce the risk that the forecast reductions in NERL's non-regulated activities will reduce the resources available to deliver airspace change. We have also made minor changes to our assumptions on the non-regulated income from London Approach (due to the consequential changes from our assumptions on NERL's Determined Costs and the addition of Biggin Hill to London Approach service).

- Pension costs. We have halved our pension deficit repayment reduction (to £18m), in addition to associated impacts of changes to our opex. We have reduced the pension deficit repayment reduction to reflect the new evidence that NERL has provided on the NERL pension position at end March 2019, which suggests that the likelihood of a surplus arising in RP3 has reduced. But we have kept half of the pension deficit reduction to reflect the high degree of uncertainty around the pension deficit position in RP3 and our concern that NERL has not provided new evidence to demonstrate that customers will benefit if a surplus arises in RP3. Noting broadly supportive feedback and further analysis on the possibility of introducing a Regulatory Policy Statement in respect of pensions, our final conclusions support the principle, and we therefore plan to consult on the form, to be in place ahead of the next triennial valuation of the NERL defined benefit pension scheme in December 2020.

- Capital expenditure (capex). We have made no changes to our draft proposals in respect of capex allowance (maintaining £667m) but note that we are retaining the cost pass through arrangements for capex and so where NERL can demonstrate that expenditure has been made efficiently then these costs can be added to its regulatory asset base and recovered from users on this basis. We have engaged stakeholders on capex and funds governance arrangements, which are designed to ensure that whilst NERL is accountable for its capital programme, it engages effectively in its delivery and is subject to additional scrutiny before making significant changes to its capex programme or seeking to use the Opex Flexibility Fund.

- Cost of capital. As a result of changes to our estimates of NERL's debt beta, and updates for latest market information and the corporation tax allowance, we have increased our pre-tax cost of capital (WACC) from 2.84% (draft proposal) to 2.91%. This results in an increase in regulatory return of £3m over RP3.

- Regulatory depreciation. The reduction in depreciation reflects further reductions our RPI inflation forecasts based on latest market forecasts. We have not made any changes to capex in our draft proposals. To reduce the RPI inflation risks faced by NERL, we propose to accept a NERL proposal to true-up depreciation and returns for the actual difference between RPI and CPI, rather than only relying on the difference forecast in advance.

The overall impact of our changes is to increase NERL's Determined Costs by £100m over RP3, compared to our draft proposals – the remaining difference between NERL's business plan and our final conclusions is £200m. Our final conclusions will provide flexibility for NERL to play its role in the delivery of airspace modernisation, are consistent with the EU cost efficiency target, and provide for lower prices over the period, which in real terms will be an average of 22% lower in RP3 compared to RP2.

Other UK costs – the UK cost efficiency target comprises the Determined Costs of NERL, the Met Office (for aviation services), DfT (the UK's contribution to Eurocontrol) and the CAA's airspace policy and regulation costs. There are only minor differences between our draft proposals and final conclusions in respect of these other costs.

Table 7: NERL RP3 Determined Costs

RP3 Determined Costs for en route (£m, 2017 prices)	NERL RBP – En route (£m)	CAA Draft Proposals – En route (£m)	Difference to RBP (£m)	CAA Decision – En route (£m)	Difference to RBP (£m)
Operating costs (excl. pensions) and non-regulatory income	1,692	1,585	-107	1,665	-27
- from staff and non-staff opex efficiency	-	-	*-71*	-	*-43*
- from non-regulatory income change	-	-	*-49*	-	*-24*
- from MOD contract update	-	-	*+13*	-	*+13*
- from ACOG	-	-	-	-	*+15*
- from addition to Opex Flexibility Fund	-	-	-	-	*+7*
- from changes to London Approach revenue	-	-	-	-	*+4*
- from adding Biggin Hill to London Approach	-	-	-	-	*+1*
Pension costs	416	368	-48	392	-24
- from DB deficit payment reduction	-	-	*-36*	-	*-18*
- from opex reduction	-	-	*-12*	-	*-6*
Regulatory depreciation	771	753	-18	747	-24
- from capex reduction & pass-through changes	-	-	*-9*	-	*-8*
- from change to inflation forecasts	-	-	*-9*	-	*-16*
Regulatory return	277	149	-128	152	-125
Total Determined Costs (£m, CSU-based)	**3,155**	**2,855**	**-300**	**2,956**	**-200**

Delivery incentive

Bearing in mind the additional resources and flexibility available to NERL from our decisions on its RP3 price control, users can, even more than previously, reasonably expect that NERL plays its full part in driving forward the airspace modernisation programme, and deliver its full programme effectively. To further the interests of users with respect to these matters we have also decided to introduce a new financial incentive on NERL's delivery of its capex programme and support for airspace modernisation. This will involve the CAA carrying out a broad assessment of NERL's capex delivery, supplemented by a focus on the delivery of specific milestones for programmes or projects that lead to important outcomes, linked to airspace modernisation, that benefit users. The detail of these milestones will be subject to further consultation with NERL and users but is likely to initially include:

- the DP (en route) and DP (lower) technology changes which together will provide a common platform for the Swanwick and Prestwick centres allowing for legacy escape and mutual contingency, and will provide the capacity necessary for airspace modernisation;
- the AD6 airspace change for Essex airspace which will increase capacity into Stansted and Luton airports; and
- LAMP airspace changes to modernise airspace in the South East of England to take account of the performance capabilities of modern aircraft.

The Independent Reviewer will produce an annual report on NERL's progress on delivering its capital investment programme. The report will take account of comments from NERL and other stakeholders (including airlines, airports and the AMS co-sponsors). The Independent Reviewer will particularly focus on whether NERL has done everything it can to deliver the programme, recognising that some aspects of the programme have interdependencies with actions required from other stakeholders.

We will publish the report which will be used to inform our views on NERL's delivery of programmes and outcomes.

The process will be flexible to take account of appropriate changes to NERL's capital programme over RP3 that have been agreed with users and other stakeholders through the enhanced Service and Investment Plan stakeholder consultation process.

The financial incentive, which will be embedded in a licence condition, will take the form of a penalty and will be applied if NERL fails to do everything in its control to deliver elements of its programme and that these failures lead to a detriment to the interests of users and/or it fails to play its full part in driving forward airspace modernisation. It will either be applied as a reduction in NERL's RP4 revenue or a reduction in NERL's starting RAB for RP4 (or a combination of these approaches). In deciding on whether a penalty should apply we intend to undertake both a general assessment of NERL's delivery and the delivery of the specific programme or project milestones as noted above, with a particular focus on whether NERL has done everything it can to deliver the programme. The amount of the incentive shall be capped at £36m (which has been based on NERL's return on equity on its capital investment in RP3). This assessment will be complementary to any CAA ex post efficiency review of NERL's RP3 capital programme.

Oceanic price control

There are minor changes between our draft proposals and final conclusions in respect of Oceanic. We have retained our approach to building blocks and the ADS-B data charge: -2.3% on opex (excluding ADS-B); -5% on capex, non-staff opex and ADS-B charge; and updated for latest traffic forecasts.

For transparency, we will separate Tango routes charges from the main North Atlantic crossing charge, creating four charges in total: the same core charge for Tango and North Atlantic crossing (£48/flight), and two different ADS-B data charges (£4/flight for Tango and £30/flight for North Atlantic).

We will introduce more stringent governance arrangements including ADS-B delivery metrics to cover areas such as safety performance achieved; penalties for non-delivery against these metrics, balanced with the potential to remove the -5% applied to the ADS-B data charge if satisfied with benefit delivery; and a licence condition allowing NERL to charge airlines for the ADS-B data only if the service is fully operational.