

Economic Regulation of NERL to support the implementation of a UK Airspace Design Service (CAP3063)

NATS response

7 January 2025

NATS

Summary	3
1. Design of Licence modifications to implement the Airspace Design Service	4
2. Licence modifications to implement the proposals in the Joint Consultation	7
3. Consequential modifications to the Licence	10
4. Costs of new airspace design services	12
5. Form of control, other regulatory mechanisms, and illustrative charges	14
6. Illustrative draft licence modifications	19

Summary

NATS welcomes the timely consultation by the CAA on possible Licence modifications that may be necessary and appropriate to give NATS (en Route) plc (NERL) responsibility for the UK Airspace Design Service, and possible charging arrangements that would allow NERL to recover associated costs, consistent with the broad approach set out in the prior Joint Consultation on UKADS policy by DfT and CAA. For the most part, the specific proposals for economic regulation of UKADS1 and the means of recovering costs via a new charge appear to be pragmatic and proportionate.

The overall proposition, however, does not in our view represent a fair balance for the risk borne by NATS versus the reward available.

First, the CAA's proposals offer no potential for NATS' shareholders to earn an appropriate financial return on the direct costs incurred, or on the much wider corporate 'know how', organisational capital and reputation that will be deployed in support of UKADS. Underlying financeability questions therefore arise in the proposals as drafted. For the direct costs, the majority of these should be treated as capital expenditure, creating a UKADS regulatory asset base, which would be recovered over time, including a return on capital, through user charges. As UKADS1 will be creating and funding new airspace structures, which will benefit passengers and airlines over many years, it would be more equitable for all users for the costs to be recovered over a similar time period, rather than borne solely as an in-year expense by the current generation of users.

Second, as constructed, it appears that if NERL were to breach its Licence obligations in respect of UKADS1, it would be open to fines determined by the CAA, up to 10% of NERL's total regulated revenue, and ultimately exposed to the loss of the Licence as a whole. Given the small scale of UKADS1 activities versus the rest of the licensed Core and Specified Services, and the unique stakeholder engagement and delivery challenges that UKADS1 will face, these risks appear disproportionate. This would result in a material adverse shift in the risk-reward balance for NATS' shareholders. This may have been an oversight on the part of the CAA in drafting the proposals, and it could be rectified through a specific delimitation of regulatory penalties and Licence revocation in respect of UKADS1 activities only.

We thus request that the CAA revisit the overall issue of financeability, risk and return, and reconsider its proposed financial framework.

In addition, the proposed wording of some Licence changes appears to be too prescriptive and could usefully be simplified, while retaining the definition of UKADS1' purpose, activities and accountability to stakeholders.

1. Design of Licence modifications to implement the Airspace Design Service

1.1. CAA questions for consultation

The CAA raises two questions on its overall approach:

- > views on its overall approach to establishing Licence modifications for NERL that will enable it to successfully provide the Airspace Design Service; and
- > whether this approach is consistent with its statutory duties, including in relation to safety, furthering the interests of customers and consumers, economy and efficiency, and NERL's financeability

1.2. NERL response

NERL agrees with the CAA's overall approach, to propose Licence modifications which would oblige NERL to undertake the UK Airspace Design Service 1 task, in support of the Airspace Modernisation Strategy. It also agrees that these new obligations should, so far as is practicable, be relatively high level, which would give NERL both the freedom as well as the responsibility to use its judgement in seeking to ensure compliance, as it does with other obligations in the Licence.

We also agree that obligations in the Licence could be complemented by directions or guidance given by the CAA and/or Secretary of State. This mechanism could provide for more flexibility than simply relying on the more cumbersome process of modifying the Licence. Such directions or guidance could be applied to steer the work of UKADS1 towards emerging policy priorities, noting the extensive lead times in airspace design and implementation and thus the importance of evolution in policy guidance and the subsequent period for UKADS1 to respond. They should not be used to impose upon NERL any substantively additional roles or responsibilities, which may require additional resources to deliver. Material changes in scope and resource requirements might better be implemented via Licence modification, which provides for a clear consultation process and a means of appeal.

As noted in NERL's response to the Joint Consultation, we disagree with a number of the DfT and CAA's policy proposals, against which UKADS1 is proposed to operate. Some of the areas we challenge would have implications for the definition of UKADS1' scope and funding, notably:

- > The airspace change process, where we have argued for more radical reforms than suggested might be necessary by the Joint Consultation
- > Accountability for consultation with those affected by airspace changes, where we have suggested that UKADS1 should be given accountability and funding, with scope to work closely with airports to deliver consultation and engagement activities locally
- > Airspace change support fund, where we have suggested that this public policy role would not fit well with NERL's current or proposed activities, and could be better fulfilled by a public body such as the CAA or the DfT.

Subject to these comments on the overall policy, NERL agrees with the CAA's proposed areas in which Licence modifications would be necessary, if the policy proposals set out in the Joint Consultation were to be delivered:

- > Condition 1 (Interpretation and construction) to define what NERL's role would be as the provider of the "Airspace Design Service"
- > new obligation to require NERL to undertake the role of the Airspace Design Service provider and address:
 - > the matters that NERL would be required to consider in performing that role
 - > the need for NERL, as the Airspace Design Service provider, to act transparently and impartially; and
 - > NERL's relationship with stakeholders in its role providing the Airspace Design Service
- > Consequential amendments in two main areas:
 - > how NERL's existing role in relation to airspace modernisation through maintaining the Airspace Change Organising Group (ACOG) would evolve; and
 - > other provisions, especially those that make up the financial ring fence.

With regard to the CAA's statutory duties, we agree with the CAA's reasoning that the UKADS1 proposal is fully aligned with the CAA's primary duty to maintain a high standard of safety in the provision of air traffic services. We also agree that the proposals would likely be in airlines' and passengers' interests through the more effective delivery of the Airspace Modernisation Strategy whose vision is to deliver quicker, quieter and cleaner journeys, and more capacity.

NERL has argued in response to the prior policy consultation¹ that material changes to the existing airspace change process are required to cater effectively for the complexities of multi-airport designs and deployments, and thus allow for a more efficient overall change process. If such changes are introduced, in parallel with the creation of UKADS1 and NERL's assumption of that role, then NERL would agree that the approach to the Licence modifications would likely promote economy and efficiency in the provision of these services.

NERL does not agree that the proposed regulatory policy for cost recovery would allow the CAA to meet its secondary duty "to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences". The CAA's proposals in this area amount to cost pass-through, with no margin for an appropriate return for the risks borne, and all costs charged to users in the year in which they are projected to be spent. This would result in NERL's shareholders bearing a high degree of reputational risk, reliant on the delivery performance of UKADS1 in what is acknowledged by CAA and Government as a highly complex critical national infrastructure programme with many local community, commercial and political stakeholder dimensions.

In addition, in purely financial terms, UKADS1 will require substantial working capital to fund its operations, with specific activities funded ahead of revenue collection. There will also be considerable coordination and opportunity costs for NERL in managing to provide support to UKADS1 from the depth of operational and technical experience across the company. Access to these resources and corporate 'know-how' is one of the key benefits of locating UKADS1 within NERL, as acknowledged by many stakeholder responses to the Joint Consultation. Delivering this benefit is not cost or risk free to NERL, though, which should be recognised in the financial framework.

¹ DfT/CAA, Airspace modernisation: consultation on a UK Airspace Design Service (CAP 3029), October 2024

This risk-bearing and the funding costs should be balanced with the opportunity to earn a reward via the regulated return on capital deployed by NERL's shareholders in establishing and running UKADS1 capabilities. Such an approach to capitalising the majority of costs would also benefit airspace users over time, as it would share the costs of airspace change, the benefits of which will last decades, over more than one generation of users. It would also align with the approach currently adopted for NERL's own airspace change proposal, in which the majority of costs are capitalised as they are in service of creating a new asset in the form of an airspace structure which is subsequently deployed.

In addition, the Licence modifications, as currently proposed, could expose NERL's shareholders to significant financial risk from any failure by UKADS1 to fulfil the new Licence obligations – these risks could amount to regulatory fines of up to 10% of NERL's total turnover or, at the extreme, loss of NERL's Licence for all of its core and specified services. The nature of UKADS1 activities carries significantly more delivery risk associated with external stakeholder management than NERL's current suite of activities, and will be operating in a context of very high visibility and accountability to the Government, CAA and aviation stakeholders. It is likely therefore that any failure by UKADS1 to meet ambitious targets and goals established by the Airspace Modernisation Strategy could be challenged by some stakeholders as potentially a failure on the part of NERL to meet a Licence obligation in respect of UKADS1. If the CAA were to make a finding of Licence breach in such a situation, the risk of financial loss to NERL's shareholders (noted above) would be very significant. Without some modification to de-limit this risk, the balance of financial risk and reward for NERL's shareholders would be very materially adversely affected. Against this background, NERL does not consider that the CAA's approach is consistent with its duty "to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences"².

We provide specific comments on the CAA's proposed consequential amendments to the Licence (chapter 3) and the illustrative draft Licence modifications (chapter 6), including suggestions to remedy the identified adverse impact on NERL's financeability.

² Section 2(2)(c) Transport Act 2000

2. Licence modifications to implement the proposals in the Joint Consultation

2.1. CAA questions for consultation

The CAA raises three questions on:

- the prospective obligation on NERL to perform the Airspace Design Service and the approach to setting the geographic scope of these activities;
- the prospective obligations on NERL with respect to its relations with third parties, including through the Advisory Board and working arrangements with partner organisations; and
- the approach to NERL's new obligations and those existing obligations relating to ACOG.

2.2. NERL response

NERL's responses to these questions of UKADS1 role definition, geographic scope and relations with third parties should be read in conjunction with our response to the prior DfT/CAA policy consultation.

2.2.1. Defining NERL's role

The description of NERL's role as UKADS1 includes a number of aspects which NERL has challenged in its response to the policy consultation, notably:

"2.5 NERL, in providing the Airspace Design Service, to combine airspace change proposals such that the outcome is a single design that prioritises maintaining a high standard of safety and secures system-wide benefits and overall network optimisation." [emphasis added]

NERL does not support this approach to amalgamating all existing proposals in the London and South East cluster, for reasons explained in response to Question 12 in the policy consultation:

- NATS opposes the proposed transition arrangements for current ACPs as they assume continuation within the current CAP1616 and Masterplan framework. NATS has been clear that it believes that the current regulatory process will not support the timely and effective delivery of airspace modernisation in the London cluster. NATS believes that an alternative regulatory model, underpinned by secondary legislation, is required to enable effective delivery.
- NATS' view is that amalgamation would invalidate the previous work of the sponsors as the new ACP would require a single Statement of Need and set of Design Principles. As the sponsors developed their Stage 2 options based upon their own bespoke Statement of Need and Design Principles, their options could be invalid under the amalgamated ACP.

"2.8 The airport or other airspace change partner would be responsible for the safety case, implementation of the change, and certain elements of consultation, working collaboratively with NERL as the Airspace Design Service provider and sponsor of airspace change proposals."

NERL proposes a more central coordinating role for UKADS1 with respect to consultation activities, for reasons explained in response to Question 11 in the policy consultation:

- NATS agrees that consultation and engagement must involve both UKADS1 and the airports working together. Airports have built, and invested heavily in maintaining, extensive

stakeholder relationships; that has intrinsic value which should not be lost. Working together must be carefully coordinated.

- UKADS1 must, however, have accountability for consultation and engagement. UKADS1 should set the framework for consultation and ensure that airports are appropriately engaged and following the requirements set out in that framework. This framework needs to be more directive than is suggested in the consultation document.
- Without such central direction, multiple airports leading their own independent stakeholder engagement and consultation would likely lead to inconsistencies and confusion for stakeholders. Additionally, this would give an effective veto to each individual airport to decide whether to progress, for instance if it were unwilling to engage and consult on designs that it may not fully support.

"2.11 [description of] the activities that would be required as part of the provision of the Airspace Design Service, namely:

- *assessing, shortlisting and selecting proposals promoted by third parties;*
- *combining those proposals to develop a single design proposal for changes to UK airspace; and*
- *sponsoring that proposal through the Airspace Change Process."*

In NERL's view, this description is built around too restrictive a concept of UKADS1' role as a compiler of existing airspace change proposals developed by airports in the South East cluster. This would be too constricting, and one that is unlikely to enable UKADS1 to construct a more holistic, integrated design of airspace structures across the region. To deliver that better outcome, NERL as UKADS1 would need to be tasked with developing its own proposals, informed but not constrained by prior design work produced by previous airport sponsors of individual airspace change proposals (ACPs). A regulatory process, defined by the CAA operating within Air Navigation Orders, sets out what UKADS1 needs to do to deliver an airspace change, so this level of detail need not be included in the licence.

2.2.2. Geographic scope

NERL agrees that the initial UKADS1 scope should be the London TMA cluster. Specifically, this encompasses bringing forward Airspace Change Proposals to modernise the Instrument Flight Procedures and ATS Route Structure to deliver airspace modernisation within the London TMA cluster of the UK Airspace Masterplan, as defined in CAP2312B and the Addendum to CAP2312A. This includes the redefining of airspace boundaries and/or classifications to support these changes.

It does not, however, agree that it would be appropriate to allow for changes to the geographic scope of the Airspace Design Service to be made without amending the Licence. Such changes could be significant in either geographic scope and/or the nature of the airspace involved (e.g. lower airspace with potential for integrated operations including uncrewed aircraft, military danger areas). In either case, the resource and risk management considerations for NERL could be significant. As such, these change in scope would be fairly and transparently achieved via a consulted licence modification, providing NERL with a right of appeal.

2.2.3. UKADS1' obligations and factors to consider

NERL agrees with the proposal for a relatively simple obligation set out in a new provision in the Licence, reflecting the objectives identified in the Joint DfT/CAA Consultation. The factors for UKADS1 to consider look relevant, build upon current practice and are simply expressed in illustrative Licence modifications. It is helpful for UKADS1' ability to make medium term plans for

resource allocation that the proposed CAA/Secretary of State guidance, to inform UKADS1' prioritisation, will only be effective after a formal consultation process.

2.2.4. Advisory Board

NERL supports the proposed creation of an Advisory Board to provide oversight of UKADS1' activities. NERL is content that these proposals give sufficient reassurance that potential conflicts of interest arising from NERL providing airspace design services through UKADS1 are mitigated.

2.2.5. Relations with stakeholders

"2.33 While NERL would retain overall responsibility for delivery, we consider that these proposals could be implemented relatively simply by placing an obligation on NERL to use reasonable endeavours to enter into working arrangements covering the specified matters, such as roles and responsibilities in relation to consultation."

As noted in our response to the Joint Consultation, NERL considers that UKADS1 must have accountability for consultation and engagement. UKADS1 should set the framework for consultation and ensure that airports are appropriately engaged and following the requirements set out in that framework. This framework needs to be more directive than is suggested.

2.2.6. UK Airspace Design Fund

NERL is opposed to UKADS1, as part of NERL, administering the UK Airspace Design Support Fund. The allocation of a limited fund between different bids will involve policy judgements about their respective merits, their alignment with AMS priorities, and the degree of financial support each bid merits. NERL therefore believes it would be more appropriate for the CAA to administer the fund as co-sponsors of airspace modernisation and as a public body with some experience of allocating public funds. This aligns with the CAA administering the current Airspace Modernisation Strategy Support Fund.

2.2.7. The role of ACOG

NERL supports UKADS1 assuming the programmatic and coordination functions from ACOG for the London cluster. NERL also supports ACOG retaining its current functions for clusters that are not delivered by UKADS1, and the proposed simple Licence amendment to limit the geographic scope of ACOG to areas where NERL's role as the Airspace Design Service provider does not apply. NERL believes the UK Airspace Masterplan is no longer required for clusters that are delivered by UKADS1.

3. Consequential modifications to the Licence

3.1. CAA questions for consultation

The CAA raises questions about its proposed consequential changes to the Licence in the following areas:

- > Condition 5 (Availability of resources and financial ringfencing);
- > Condition 6 (Regulatory accounting requirements);
- > Condition 7 (Requirement to maintain an intervention plan);
- > Condition 8 (Requirement for mandated independent directors and corporate governance); and
- > Condition 9 (Prohibition of Cross-Subsidy).

3.2. NERL response

The responses below are provided in high level terms reflecting NERL's views on the principles set out in the consultation document. However, notwithstanding those high-level views, NERL has further comments on the detailed drafting (albeit that drafting is intended to only be on an illustrative basis) which are set out in section 6 below.

3.2.1. Condition 5

The approach proposed by the CAA seems to be logical, in that UKADS will be a mandated service and as such should be included within the financial ring fence rather than made part of the 4.5% *de minimis* commercial revenue rules. The natural corollary of that proposal is (as set out by CAA) that as per **Condition 6**, the Regulatory Accounts should include UKADS. However, CAA postulates that it should naturally follow that the 4.5% commercial revenue *de minimis* calculation should be adjusted to remove the revenue associated with UKADS activity.

We do not agree with this conclusion, which appears not be fully argued, pros and cons, by the CAA. The original and enduring purpose of the 4.5% threshold is aimed at establishing a level above which unregulated activity, not related to its Core and Specified Services, might become a distraction to NERL. If NERL's activities expand in proportion to the UKADS revenue, then logically NERL should be able to cope with higher levels of commercial activity (in absolute terms) as it becomes a larger organisation. This reasoning would argue against the CAA's conclusion. Although the current level of unregulated UKATS and Oceanic revenue is currently at 1% of total regulated revenue³, and thus somewhat below the 4.5% cap, it is likely that the share of unregulated revenue will rise over time, as NATS follows through on its growth strategy. In this context, we consider it important to include the UKADS1 revenue within the denominator of regulated revenue against which the 4.5% cap for unregulated revenue is measured.

³ Regulatory Accounts for 2023, Table 22, June 2024

In addition, there are potentially unintended complications that arise from the detailed drafting proposals which create several anomalies and conflicts which NERL would find unacceptable. These are addressed in detail in section 6 below and while changes to drafting would address most of them, there are underlying principles that should be considered beyond the accuracy of the drafting.

3.2.2. Condition 7

NERL agrees with the CAA's proposal that UKADS should be included in the scope of the intervention plan. This appears a logical step with little additional work once the framework of the document has been expanded to cover UKADS.

3.2.3. Condition 8

NERL agrees with the CAA's proposals that the oversight provided by the Advisory Group in combination with the existing requirements for independent directors will be sufficient to ensure effective delivery by UKADS. But, for reasons of simplicity of governance and economic efficiency, NERL continues to strongly support the existing waiver of the requirement for independent directors on the premise that the partnership directors appointed by the DfT demonstrate sufficient independence to obviate the need for separate independent directors. The proposed drafting includes new requirements for independent directors that would require demonstrated independence from airports and airlines. That requirement would not affect the eligibility of the current partnership directors and the DfT could, were it so minded, add that requirement to future recruitment criteria for its partnership directors. However, given the proposals for extensive accountability of UKADS activity to the Advisory Board, the additional requirement for independence from airlines and airports (whether in the form of independent directors or partnership directors) appears to be unnecessary. It would also prevent the appointment of independent directors who had relevant and recent experience of airlines or airports and would therefore be likely to add more value from that experience than might be risked by their de minimis ability to influence the activity of UKADS, as overseen by the Advisory Group.

3.2.4. Condition 9

NERL agrees that it would be appropriate to designate UKADS as a separate business and therefore subject to a prohibition of cross subsidy in the same manner as the Oceanic and En Route services are prevented from cross subsidising each other. That cross-subsidy prohibition would not prevent the efficient sharing of resources across the three business areas. However, careful drafting is required which is addressed more fully in section 6 below.

4. Costs of new airspace design services

4.1. CAA questions for consultation

The CAA raises two questions with regards to the costs of new airspace design services:

- > the estimates of costs of providing the Airspace Design Service and the Airspace Design Support Fund; and
- > any other information stakeholders have on costs or the assumptions it is reasonable to make in projecting costs for the period 2025 to 2035.

4.2. NERL response

4.2.1. Cost projections for the Airspace Design Service

NERL notes that the cost projections for CAA by its consultants Egis were based on a number of assumptions, some of which NERL considers not to be consistent with its own view of the scope of UKADS1 and the airspace change environment in which it should operate. As a result, these cost projections may not be a close predictor of UKADS1's actual design service costs. Given that the CAA's proposed regulatory model for UKADS1 is recovery of actual costs, then any particular projection made now is unlikely to be significant to the proposed Licence modifications to set up UKADS1.

NERL has the following comments on the assumptions adopted by Egis for the purposes of cost projection:

- > Deployments: this term is misleading, and it would better to state the assumption as UKADS1 should be able to manage a maximum of two concurrent developments. The limiting factor on the rate of implementation of airspace changes designed and developed by UKADS1 is likely to remain the need to manage any adverse impact on air traffic control service performance during transition
- > UKADS1 would be required to follow the CAA's CAP1616 process: NERL disagrees with this assumption as outlined in our response to the Joint Consultation
- > UKADS1 would mobilise in mid-2025: NERL suggests that this date is at the earliest end of a range, and meeting such a milestone would depend upon a number of other policy and regulatory processes reaching early conclusions
- > UKADS1 staffing: the staffing model has yet to be determined due to uncertainty of UKADS1 scope. On NERL's current understanding and initial assessment of the range of skills required, it is likely that UKADS1 would use external specialist support in several areas, not just the two cited here (communications, engagement).

Given the significant uncertainties around airspace change regulatory process within which UKADS1 will operate, and around the responsibility for funding and delivery of consultation on proposed changes (which hitherto has been one of the more costly elements of the whole change process), NERL considers that the cost estimates of £10-16m per year over the decade to 2035 should be considered as 'order of magnitude' only at this stage. UKADS1 will need ready access to airspace design facilities to expedite its work in development and evaluation of potential changes. It is too early in the planning for UKADS1's activities to put a range or cap on the potential

scale of investment needed to create and maintain the facilities required. As such, these cost estimates should not become binding on UKADS1, nor should NERL have to justify its initial and ongoing costs by reference to this early estimate.

4.2.2. Cost modelling and projections for the Airspace Design Support Fund

As noted in our response to the Joint Consultation on UKADS policy, we are opposed to UKADS1, as part of NERL, administering the UK Airspace Design Support Fund. The allocation of a limited fund between different bids will involve policy judgements about their respective merits, their alignment with AMS priorities, and the degree of financial support each bid merits. NERL therefore believes it would be more appropriate for the CAA to administer the fund as co-sponsor of airspace modernisation and as a public body with some experience of allocating public funds. This aligns with the CAA administering the current Airspace Modernisation Strategy Support Fund.

We have no insight into the potential range of costs which the Support Fund would cover and thus no comment on the CAA's cost estimate of £6-8m per year.

4.2.3. NR23 cost allowances

We agree with the CAA's proposals that the costs to be funded by a new Airspace Design Charge during NR23 should include only the incremental costs of sponsoring additional airspace change proposals in scope of the Airspace Design Service (for the London TMA region) and providing the Airspace Design Support Fund, over and above the NR23 capital expenditure allowance to take forward required airspace design functions in upper airspace.

5. Form of control, other regulatory mechanisms, and illustrative charges

5.1. CAA questions for consultation

The CAA raises four questions on:

- > whether the cost pass through approach for recovering costs related to the Airspace Design Service and the Airspace Design Support Fund is appropriate;
- > whether these costs should be recovered from users in the year that they are incurred;
- > the duration of the initial charge control for the Airspace Design Service and Airspace Design Support Fund, proposed as 2½ years and then aligned with NERL's main price control reviews; and
- > the illustrative charges set out.

5.2. NERL response

NERL's main concern with these proposals are that they do not reflect the investment in airspace infrastructure that will be the primary focus of UKADS1' activities – the 'pay as you go' proposal would not be in airlines' or passengers' interests, and does not provide NERL with the appropriate-term financial framework to support these activities.

5.2.1. Options for cost recovery

We agree that an approach based on cost pass-through (CAA's Option 1) is likely to be most effective in supporting the delivery of the Airspace Design Service. We also agree that the Airspace Design Support Fund should be recovered on a cost pass-through basis. In each case, the strong rationale for cost pass-through is that the future costs of airspace change activities, both those led by UKADS1 and those conducted by airports outside the South East of England but funded via the Support Fund, are inherently difficult to forecast with any degree of validity even a few years ahead. An alternative of a binding cost budget set some years in advance on the basis of uncertain forecasting would risk slowing airspace change activity unnecessarily and thus delaying delivery of the substantial societal and economic benefits which could otherwise be achieved.

5.2.2. Profile of cost recovery over time

We do not agree that the costs of the Airspace Design Service should be treated as an operating cost. This would not be in the interests of airlines and passengers. It would also represent a departure from the current practice of capitalising costs which lead to the creation of a new airspace 'structure' within which NERL then operates. Given the distinct risks to NERL and wider organisational capital that will be deployed in support of UKADS1, and in line with well-established UK regulatory practice, we consider that the long term investment by shareholders in UKADS1, within NERL, should be able to earn a return on capital deployed as on other regulated assets.

Airlines and passengers will benefit for some decades from the fundamental improvements in the efficiency and capacity in the London TMA which UKADS1 will be tasked with delivering. The better way to match these benefits to the costs of delivering them would be for the majority of the costs of UKADS1 to be treated as capital expenditure. This would smooth the recovery of costs over a similar period to the benefit profile. NERL would earn a return on capital annually on a

UKADS1 Regulatory Asset Base, following a similar approach to that adopted for the UKATS RAB, and receive the return of capital (via regulatory depreciation) over a 15-year period starting when the airspace change came into operation. By contrast, the CAA's proposal would result in the current generation of airlines and passengers paying all the costs of airspace modernisation for the London and Southeast cluster, in advance of receiving any benefits.

The CAA's proposal is contrary to current practice whereby NERL capitalises costs for those activities (design, consultation, production of airspace change proposal and supporting evidence) which lead to the creation of a new airspace structure subsequently operated by NERL in the en route and/or London Approach services. For example, in the Swanwick Airspace Improvement Project (SAIP) Airspace Deployment 6 (AD6), February 2022, to London Luton Airport's arrival flightpaths, NERL's total costs of £6.8m were categorised 60% capital, 40% opex. This approach is aligned between NERL's regulatory and statutory accounting, but would need to be reviewed for UKADS1 to ensure accounting requirements did not invalidate the intended funding mechanism.

The CAA argues that treating Airspace Design Service costs as operating expenditure would be preferred, as the alternative of capitalising some or all of the costs would lead to higher levels of average charges overall as they involve allowances for regulated return. This appears to overlook present value cost assessment, a fundamental principle of regulatory economics. Costs over time should be compared to current year costs by using a relevant discount rate, based on the concept of time preference; £1 of benefit or cost today is valued more highly than £1 next year (abstracting from inflation effects). Airlines' typical discount rates are, on average, circa 9%⁴. As such, capitalising Airspace Design Service costs would likely result in users paying lower present value total costs (discounted at their discount rate) than if all costs were treated as opex.

As noted in our response in chapter 1, an approach to cost recovery based entirely on opex treatment of Airspace Design Service costs would be contrary to the CAA's statutory duty to enable NERL to finance its regulated activities without undue difficulty. Without the opportunity to earn a return on capital invested, shareholders would face a deteriorating risk-reward balance if NERL took on the UKADS1 role on the financial terms which CAA currently proposes. In turn, this would raise questions for shareholders about their support over the long term in this growing function. We strongly encourage the CAA to revisit the overall issue of financeability, risk and return, and to reconsider its proposed financial framework. This should recognise the need to provide a fair, transparent and predictable return to shareholders over the long term in order to secure the investment needed in the coming decade and beyond.

5.2.3. Recovery of Airspace Design Support Fund costs

We do not agree with the CAA's proposal that the Airspace Design Support Fund costs should be treated as if they were operating costs and recovered in period, for similar reasons to those set out above. The Fund will be used to support the creation of new airspace structures to the benefit of airlines and passengers for decades to come. As we note, a fairer allocation of costs to those who will benefit would be achieved by capitalising these and recovering over decades.

If these costs were incurred by airports (in the absence of any support fund), then they would be capitalised in line with accounting principles. Capitalisation of Support Fund costs in the UKADS1 RAB would mirror this approach.

⁴ IATA, Global Outlook for Air Transport, June 2024

5.2.4. Duration of control

We agree that a short initial period for a UKADS1 price control and charge, aligned with the current NR23 period, would be the most appropriate, and most likely to be effective, in supporting the delivery of the Airspace Design Service as proposed in the Joint Consultation. However, given that we propose that a large part of the costs incurred in the period 2025-28 should be capitalised in a separate UKADS1 RAB, the CAA would need to establish in 2025 a clear Regulatory Policy Statement for the future recovery of and return on this RAB over subsequent price control periods.

5.2.5. Other regulatory mechanisms

We agree that it would be necessary to include a **correction factor** to account for traffic deviations from forecast traffic, which would be applied through an adjustment to required revenue in year $n+2$.

We agree that a full actual cost recovery approach would reduce the need for **inflation adjustment** of projected costs. Nevertheless, as differences between projected and actual costs would be recovered with a two-year time lag, there would need to be an inflation adjustment to update the nominal cost difference incurred in year n and the recovery of that difference in year $n+2$. Without such a mechanism, UKADS1 would systematically under-recover, in real terms, the excess of outturn costs above planned costs.

5.2.6. Delivery incentives

We agree that the wider legislative and regulatory framework will provide a number of routes for Government, CAA and aviation stakeholders to hold NERL to account for delivery. As discussed in the Joint Consultation, the NATS Board would be accountable for delivery of the Airspace Design Service to the DfT and CAA as co-sponsors of airspace modernisation. Also, any expanded definition of air traffic services to encompass airspace design services would mean NERL's duties under section 8 of the Transport Act 2000 would also apply, as would the licence obligations discussed in chapter 2 of the CAA's licence consultation. Against that background, we do not consider that any additional financial incentives attached to specific delivery milestones would add helpfully to the strong focus which the NATS Board will have on UKADS1's efforts to meet stakeholder delivery expectations.

There are other factors which would also argue against delivery incentives. First, they would add to the downside financial risk faced by NERL's shareholders, as such incentives are invariably asymmetric in likely outcome towards penalty, either by design or by practical constraints. On the latter, it would be impossible to bring forward substantially a reasonably specified delivery milestone, the achievement of which is reliant on information processing and decision-making by other parties (including the CAA). To aim to do so would risk undermining some of the necessary steps in airspace change design, safety assessment and environmental impact analysis, and could lead to lower quality airspace change proposals which do not meet stakeholder or CAA requirements. (NB This argument does not detract from NERL's wider proposal to reform the airspace change process and consultation requirements, via amended Air Navigation Orders, Guidance and a revised CAP1616 CAA Process for Changing the Notified Airspace Design. Such changes would enable shorter timelines to be established for airspace change in the London TMA than are currently feasible.)

Second, in the early years of UKADS1 operation, and assuming that material changes are made to airspace change process and consultation requirements, UKADS1 will be operating in a new relationship with airports and the CAA, and within an updated regulatory framework, affecting how it operates, what it needs to deliver and how it prioritises activities. This would create a high degree of change in the operating environment for UKADS1, against which it would be very difficult to determine any delivery milestones with sufficient credibility to tie financial incentives to such outcomes.

5.2.7. Charge design, structure and level

We agree that the costs of UKADS1 (Airspace Design Service and Support Fund) should be recovered via a new charge to be paid by users of UK Flight Information Region en route airspace – a separate charge would provide maximum transparency to users for the costs of delivering Airspace Design and Support Fund services, albeit this would entail some additional processing and administrative cost compared with the alternative of cost recovery via the current en route charge. The definition of users paying the UKADS1 charge should include aircraft overflying the UK, as well as those landing, both within the London TMA and across the rest of the UK, for the reasons set out by the CAA.

With regard to the structure of charges, we agree that a charge per service unit, rather than simply per flight, would better align with principles of proportionality and user pays. Airlines, NERL and the Eurocontrol Central Route Charging Office (CRCO) are well accustomed to an en route charging system based on service units defined by reference to each flight's distance and maximum take-off weight.

Implementation by way of a new separate charge, based on chargeable service units defined (as for the current en route charge by reference to aircraft maximum take-off weight and distance flown in the UK FIR), would entail some additional cost and risk to UKADS1 (NERL) and to airlines:

- > NERL would have another charge to manage and account for,
- > airline customers would have another invoice to process, creating another layer of administration in the system,
- > the amounts being billed would likely be high volume, low value. Credit control would therefore be more challenging, and NERL would have to bear risk associated with a high number of small debtor balances,
- > a new separate charge would need to comply with upcoming e-invoicing directives from the EU and would require integration with numerous billing systems.

NERL does not maintain a database of aircraft maximum take-off weights (MTOW) which makes this methodology more involved to deliver than recovery via the current en route charge. There are three options:

- i. NERL outsources all billing to Eurocontrol Central Route Charging Office, via a commercial contract, for a fee, and subject to service level agreements. This approach is not without its challenges (e.g. what currency to bill in, who bears any foreign exchange risk, credit control procedures and risk, EU versus UK legislation). These terms could all differ from existing en route charging methodologies and processes.
- ii. NERL obtains, via a licence from the CRCO, the aircraft MTOW database, then builds its own billing systems to raise a new charge based on MTOW and distance, and ensures it has sufficient resource to manage the billing and collection processes.
- iii. NERL builds its own MTOW database, builds its own billing systems, and ensures it has sufficient resource to manage the database, billing and collection processes.

None of these options has been fully assessed or costed. On first pass, however, Option 1 would appear to be the simplest way to implement a charge. CRCO already provide similar billing services for non en route income to other nations and has the necessary system capabilities to calculate chargeable service units (CSUs) based on distance and weight. We would need to ensure that the data NERL currently provides would be compatible with CRCO requirements for the new UKADS1 charge to be implemented.

Option 2, if it were possible to obtain a licence to use the MTOW data, would then entail a significant amount of subsequent work to design and build a system capable of holding rates, calculating routings and distance and being able to calculate resulting billing amounts. NERL would need to update its SAP systems to issue relevant invoices, introduce specific credit control procedures, increase and maintain NERL's customer database, and enhance its route charges and credit control resources to enable this. We estimate a period of 6-12 months to implement such a new route charge system, and a further period to make changes in the SAP system. Option 3 would add to the implementation challenge of option 2 by adding the requirement to build an MTOW database (by individual aircraft) from scratch, which would then need to be maintained via regular airline updates via a customer portal. We anticipate that there would be significant airline opposition to the imposition of this additional administrative effort, for the sake of a small new UK specific charge, when at present they enter their respective fleet data once for the whole of the Eurocontrol network area.

We note the CAA's estimates of the potential UKADS1 charge (on a per flight or per service unit basis).

6. Illustrative draft licence modifications

6.1. CAA questions for consultation

The CAA proposes illustrative draft licence modifications in the following areas and seeks views on these.

- > Condition 1 (Interpretation and construction)
- > New Provisions: Obligation to provide the Airspace Design Service
- > Condition 5 (Availability of resources and financial ringfencing)
- > Condition 6: Regulatory accounting requirements
- > Condition 7: Requirement to maintain an intervention plan
- > Condition 8: Requirement for mandated independent directors and corporate governance
- > Condition 21b: Control of Airspace Design Charge

6.2. NERL response

In general terms, NERL welcomes the attempt to expand on the high-level principles, but there are areas of the drafting that introduce anomalies and conflicts which, if carried through, would present significant challenges to the acceptability of the high-level proposals. While some of the proposed drafting would likely be significantly amended to reflect the eventual form of UKADS and its remit following this consultation, there are other areas of the drafting proposals that introduce issues that are not specifically addressed elsewhere in NERL's response:

6.2.1. Condition 1 (Interpretation and construction)

New definition of **Airspace Design Service** – as set out in section 2.2 above, NERL believes the service should not be as described in this proposed definition. Once the nature of the service has been finalised, the drafting of the definition can be considered in detail.

New definition of **Airspace Change Process** – subject to any consequential changes arising from the consultation, NERL has no objections to the form of this new definition.

Modification of definition of **Permitted Purpose** – NERL agrees with the proposed change.

Modification of definition of **Separate Business** – NERL agrees with the proposed change.

6.2.2. New Provisions: Obligation to provide the Airspace Design Service

NERL believes that there are few meaningful comments that can be made on the specific drafting in this section, on the basis that the drafting is largely based on concepts which NERL expects to materially change as per its comments in section 2.2 above. However, subject to those material changes there are a number of specific comments that NERL would like to highlight at this stage:

Part A: requirement to provide the Airspace Design Service

NERL is comfortable with the overall structure of the drafting in this section, but the definition appears to both assume incorrectly that UKADS1 will consolidate its airspace change plans into a single airspace change (rather than individual clusters of changes as described in section 2.2 above), and that the airspace change process defined by the CAA's CAP1616 guidance will continue to apply in its current form to UKADS1 design activity.

In addition, the drafting proposes (paragraph 1) that the geographic area within UK airspace in respect of which UKADS1 will have design accountability can be amended by the Secretary of State 'from time to time'. As a Licence condition, this presents NERL with a risk that it will be required to take on additional accountability without any consultation on the proposal. Consultation might well be expected, but since the initial phase, UKADS1, is intended to be the London TMA and any change to UKADS2 with a wider scope would not be until well into the NR28 NERL regulatory period, it would seem unnecessary to include this flexibility. It would be preferable for NERL if the UKADS1 phase specified the fixed geographic airspace requirement as part of the Licence condition. Any subsequent expansion to UKADS2 geographic areas of activity would then be the subject of further significant consultation and related Licence condition changes.

Part B: The Licensee's obligations on how it shall deliver the Airspace Design Service

It appears to NERL that the proposed drafting in this section (paragraph 8) potentially confuses the respective roles and responsibilities of UKADS1 and third parties. As drafted, this paragraph would allow for "third parties, including airports and the Ministry of Defence, ... [to] seek ... to initiate changes to UK airspace needed to deliver the Purpose". This description of roles appears to refer to an end state (for UKADS2) in which other proposers would suggest changes for UKADS2 to deliver. This would not be the case for UKADS1, whose scope is (at least initially) limited to controlled airspace change in the London TMA cluster, and (as we propose) any subsequent changes in scope defined by licence modifications.

Part C: the arrangements for an Advisory Board to assist the Licensee in providing the Airspace Design Service

As set out earlier, NERL strongly supports the concept of the Advisory Board and the specifics of its remit expressed in the draft clauses. However, NERL has concerns that the adoption of the generic reference to "UK airspace" in the context of those obligations will create uncertainty about the purpose of UKADS1. In particular, the following paragraphs (where underlined) create generic obligations to include the interests of uncontrolled airspace which might conflict with the aim of optimising the flows in controlled airspace:

(b) secure that NERL operates in the best interests of the system of UK airspace overall;

(d) secure that the Licensee demonstrates transparent, fair and effective decision-making, in the best interests of UK airspace without unreasonably favouring particular person or groups of persons (including itself);

NERL suggests either that the generic term 'best interests of' is replaced by a concept of 'efficient use of' UK airspace or that the reference to 'UK airspace' is deleted from these clauses and replaced by a concept of the 'best interest of airspace users overall'.

Part D obligations in respect of interested parties

NERL has no specific comments on the proposed drafting in this section.

6.2.3. Condition 5 (Availability of resources and financial ringfencing)

In general terms, NERL supports the concept of integrating the UKADS1 service into the financial ringfencing obligations and the associated drafting proposals. However, NERL has some specific comments as follows:

Paragraph B13 suggests the principle that the UKADS1 service should be added into the definition of Permitted Purpose and that this will in particular make the service subject to the obligations set out in paragraph 2 of Condition 5, which states that:

"The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, fixed and moveable assets, rights, licences, consents and facilities, on such terms and with all such rights as shall ensure that at all times it is able to:

(a) carry out its Permitted Purpose activities; and

(b) comply in all respects with its obligations under the Act and this Licence including, without limitation, its duties under section 8 of the Act."

NERL agrees that UKADS1 should be structured as an additional service under the Licence. However, the Permitted Purpose definition only includes the En Route and Oceanic services and (rightly) omits both the remaining Core Services and the Specified Services. This accords with section 8 of the Act and customer expectations, which are that NERL has an overriding obligation to deliver a safe service and additional, but second order, obligations to deliver reasonable levels of operational service. NERL also has an existing obligation to develop its own airspace change requirements for each of the En Route and Oceanic services which is therefore subsumed within the current definition of Permitted Purpose. However, those airspace design requirements are implicitly balanced against the safety and operational requirements of the Licence.

NERL anticipates that whatever form of charging and reimbursement mechanism is eventually applied to the UKADS1 service, it will be underpinned by assumptions of efficiency that will come about partly by sharing resources with the UK En Route and (to a lesser degree) the Oceanic services. By applying the obligations contained in paragraph 2 of Condition 5 to UKADS1 elevates the UKADS1 service to equal importance with the UK En Route and Oceanic services, in contrast to the remaining Core Services and Specified Services. This creates a risk that NERL will be obliged on occasion to prioritise the availability of its resources for UKADS1 activity over safety or operational exigencies (for example with shared simulator facilities used for both ATCO training and airspace simulation). In reality, NERL will never compromise safety and so the real risk is for NERL to be found in breach of its Licence, and subject to penalties or enforcement action, as a result of prioritising operational activity, which NERL believes all service users would expect. These concepts of additional risk to NERL and appropriate funding mechanisms are dealt with more widely in section 2.2 above. However, NERL would suggest that if the UKADS1 service is to be incorporated into the Permitted Purpose then paragraph 2 of Condition 5 should be modified along the following lines:

"The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, fixed and moveable assets, rights, licences, consents and facilities, on such terms and with all such rights as shall ensure that at all times it is able to:

(a) carry out its Permitted Purpose activities; and

(b) comply in all respects with its obligations under the Act and this Licence including, without limitation, its duties under section 8 of the Act

provided always that nothing in this Condition 5.2 shall require the Licensee to prioritise the availability of its resources in favour of the Airspace Design Service to the detriment of the En route (UK) Business, the En route (Oceanic) Business or any business or activity within the limits of Condition 5.9 to 5.12."

Paragraph B16 assumes that there will be no transactions between the Airspace Design Service and either of the Oceanic and UK En Route services. NERL disagrees with this assumption. Both in the interests of efficiency and in order to access appropriate skill sets, there will be sharing with the UK En Route service and, less so, the Oceanic service. For example, as referred to earlier, simulator facilities will be shared, requiring financial transactions between the services in order to avoid cross subsidisation. As a result, Condition 5.12(a)(iii) should be revised to state as follows:

"iii) transactions which the En route (UK) Business, ~~and~~ the En route (Oceanic) Business, and the Airspace Design Service make with each other;"

Paragraph B18 states that it is not clear that the *de minimis* activity threshold should include the revenues from the Airspace Design Service. As set out in section 3.2.1 above, NERL believes strongly that these revenues should be included. The definition of Connected Business should therefore include the Airspace Design Service as should the definition of En route Businesses.

6.2.4. Condition 6: Regulatory accounting requirements

NERL supports the proposed drafting in this section.

6.2.5. Condition 7: Requirement to maintain an intervention plan

NERL supports inclusion of the Airspace Design Service in the intervention plan but notes that the drafting change referred to above, to include the Airspace Design Service in the definition of En route Businesses, would achieve this end without further amendments to this Condition.

6.2.6. Condition 8: Requirement for mandated independent directors and corporate governance

As set out in section 3.2.3 above, NERL continues to support the concept of independent directors, as currently embodied in the partnership directors appointed by DfT pursuant to a waiver from CAA. However, we regard any additional requirement for such directors to be independent of recent connections with airports and airlines as unnecessary and, as a result, would not support the proposed drafting changes to Conditions 8.4, 8.5 and 8.6.

In addition, NERL notes that a drafting change proposed for Condition 8.9 attempts to introduce CAA consent to the extension of appointment of independent directors past their initial eight-year term. Such a change does not appear to be related to or justified by any change of circumstances arising from the introduction of the Airspace Design Service, and NERL strongly objects to the proposal.

6.2.7. Condition 9: Prohibition of Cross Subsidies

NERL notes that the detailed drafting of this section appears to be missing but would support the following change to the definition of Separate Business:

"means each of the En route (UK) Business, ~~and~~ the En route (Oceanic) Business and the Airspace Design Service taken separately from one another and from any other business of the Licensee, but so that where all or any part of such business is carried on by an affiliate or related undertaking of the Licensee such part of the business as is carried on by that affiliate or related undertaking shall be

consolidated with any such business of the Licensee (and of any other affiliate or related undertaking) so as to form a single Separate Business."

6.2.8. Condition 21b: Control of Airspace Design Charge

As explained extensively in section 1.2 above, NERL considers that the charging mechanism for the Airspace Design Charge remains an ongoing discussion and NERL has not agreed to the basic cost reimbursement structure represented by the formulae set in the draft condition. As a result, NERL considers it premature and unnecessary to review any such specific drafting.