

Guidance on NERL's capital expenditure engagement incentive

Introduction

1. NATS (En Route) plc (NERL) holds an economic licence issued under the Transport Act 2000 to provide en route air traffic services in the UK. On 29 August 2019, we published proposed modifications to NERL's licence for the economic regulation of NERL during the period 2020 to 2024 (RP3). Our proposals included introducing a financial incentive on NERL based on the delivery of its capital expenditure (capex) programme. NERL rejected the proposed modifications and on 19 November 2019 we made a reference to the Competition and Markets Authority (CMA) to investigate and report on the proposed modifications.
2. In its provisional findings the CMA did not support our proposed delivery incentive but instead provisionally found that NERL should be subject to a financial incentive based on its engagement with users on its capex programme. The CMA invited both us and NERL to submit a proposed design for a capex engagement incentive building on the CMA's initial specification, including:
 - how performance should be defined; and
 - how financial penalties would be calculated.
3. In response we produced draft guidance taking into account the provisional findings, along with other regulatory precedent, to set out the principles and procedure we would expect to follow in operating a financial incentive on NERL's engagement on its capex programme.
4. On 23 July 2020, the CMA sent us its final report on the reference. The CMA concluded that a new capex incentive based on the quality of NERL's engagement, and actions in response to engagement should be added to its licence. The CMA said that the licence should also refer to:
 - a guidance document setting out the process through which, and the basis upon which, we would assess NERL's performance under the new incentive and determine the level of penalty (if any) to be applied; and

- details of how the penalty cap should be calculated. This should provide that the level of the penalty cap will be calculated using an approach that is, and assumptions that are, consistent with that which we used when calculating our proposed £36 million capex delivery incentive penalty, but that the cap should be determined on the basis of NERL's actual capex rather than on the level of its capex allowance.
5. The CMA said that our guidance should be published alongside the licence modification and be substantially consistent with the draft guidance we submitted in response to the CMA's provisional findings, subject to the following:
- it should include a statement that the role of the Independent Reviewer (IR) would include providing its assessment of NERL's scores in relation to each relevant programme/project and criterion, following user engagement, and that this assessment should be published;
 - the scope for a penalty uplift in our proposed guidance should be removed;
 - the calculation of the standard penalty should be revised that:
 - no penalty would apply when there was an overall weighted average score of 3 or above;
 - the maximum penalty would apply when there was an overall weighted average score of 1.5 or below;
 - the penalty level would increase linearly as the overall weighted average score reduced, in units of 0.1 from 3 to 1.5;
 - our statement that appropriate adjustment may be made within RP3 if issues were identified in the first years of operation, should be qualified to highlight that such adjustments would be limited to minor refinements, unless they formed part of a more fundamental review that involved licence modifications and/or provided for appropriate appeal opportunities.

Guidance¹

6. This guidance sets out how we intend to assess NERL's performance in respect of the capex engagement incentive set out in Condition 10 of the NERL Licence. Subject to appropriate engagement and consultation, and taking account of our statutory duties, it may be revised from time to time to reflect best practice, the law and our developing experience.
7. This guidance addresses the following issues.

¹ This guidance was first published as Appendix E to CAP2011 – Economic regulation of NATS (En Route) plc: Decision on licence modifications and guidance (December 2020).

- **Measuring performance:** building upon the CMA's list of proposed criteria, we set out more details on how we intend to assess NERL's capex engagement.
- **Process and timings:** we discuss the processes and timings involved in the assessment of NERL's capex **engagement**.
- **Calculating financial penalties:** building upon the CMA's suggestions, we set out more details on how financial penalties **should** be calculated.

Measuring Performance

Criteria for assessment

8. In assessing the quality of NERL's engagement on its capex plans we intend to use the following criteria:
 1. **Timeliness:** NERL should provide information (to users, the IR and us) in a timely manner. This should include providing early warning and explanation of factors that may put planned delivery timelines at risk.
 2. **User-focus:** NERL should provide information in forms, and through mechanisms, that reflect user priorities and resource constraints, such that it is clear and accessible.
 3. **Proportionality:** the level of substantiation NERL provides should reflect the materiality of the change under consideration.
 4. **Optioneering:** NERL should seek to identify a range of different responses that might be adopted where practicable, and to provide opportunities for user and IR engagement and scrutiny of those options.
 5. **Responsiveness:** NERL should respond constructively to user, IR and our submissions, and explain clearly how it has considered and taken account of those submissions.
 6. **Mitigating/corrective actions:** NERL should take appropriate mitigating and/or corrective actions in the light of user, IR and our submissions.
9. We consider that these criteria will form a reasonable basis for assessing the quality of NERL's engagement on its capex plan. In broad terms criteria 1 to 4 address the quality of NERL's submissions, while criteria 5 and 6 address the quality of NERL's response to stakeholders.
10. We agree with the CMA's statement in its provisional findings that "*NERL's engagement with users on risks associated with its capex plan should include explicit attention being given by NERL to identifying the opex effects that may be*

*associated with different changes to that plan, and different options with respect to how NERL might respond*². The context here is that if NERL were to change its approach to capital projects and expenditure then this may have implications for the level of operating expenditure (opex) it incurs.

11. NERL should be transparent about the expected impact on opex of its capital projects and engage with stakeholders on these matters. We expect to assess NERL's approach to these matters under the 'Optioneering' criterion.

A scoring system for assessment

12. We will use a scoring system that is intended to provide sufficient clarity on how the level of any penalty would be determined while also allowing sufficient flexibility to reflect the range of circumstances that may need to be addressed. The penalty assessment process also takes account of where NERL is found to have performed well.
13. We have developed a points-based methodology to assess the appropriate level of a penalty taking account of performance across a number of areas. In doing so we have drawn upon Ofgem's Electricity System Operator (ESO) incentive arrangements.³
14. The points-based scoring system we will use is as follows.
15. For each capex project,⁴ we will score NERL for each of the performance criteria above (Timeliness, User-focus, etc.) on a scale of 1 to 5, where:
 1. = Weak
 2. = Poor
 3. = Average ('baseline expectations')
 4. = Good
 5. = Excellent
16. This scoring system is directly based on the ESO arrangements. It is based around the concept of 'baseline expectations', which for the purpose of the incentive mechanism means a reasonable level of performance (as described further in Figure 1 below).

² [NATS \(En Route\) Plc/CAA Regulatory Appeal – Provisional findings report, paragraph 8.78 \(March 2020\)](#)

³ https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

⁴ Below, we discuss whether we would assess NERL's performance for each individual capex project, whether we would assess its performance at the level of capex programmes (i.e. with multiple projects per programme), or whether we would agree with airspace users and NERL to consider only a shortlist of projects which are identified as high priority for airspace users.

17. The IR will score the quality of NERL's capex engagement in two rounds, with only the scores from the final round being used for the calculation of any penalty payments. This would allow NERL early indication as to where we deem that they are exceeding/falling below baseline expectations. NERL would then have scope to adjust and improve the quality of its engagement before the final round of assessment. We will publish the IR's scores.
18. We will take account of the findings of the IR and representations from stakeholders (including NERL) in forming our assessment. We will make the final decision on scoring NERL's performance. If our score is different to the IR's score we will clearly explain why we have done so. Nonetheless, the final penalty (if any) will be calculated and applied at the following price control review, which will provide NERL with an opportunity to appeal (in addition to its procedural rights to judicial review). Wider issues on timing of the various elements of these incentive arrangements are discussed further below.
19. Guidance on how scoring could be applied in practice is provided in Figure 1.

Figure 1 Guidance on scoring

	Underperformance		Baseline	Outperformance	
	Weak (1)	Poor (2)	Average (3)	Good (4)	Excellent (5)
1. Timeliness	Substantial delay in providing information, very little early warning of factors that may affect delivery.	Some delay in providing information, limited early warning of factors that may affect delivery.	Information provided in a timely manner, reasonable early warning (where possible) of factors that may affect delivery.	Information provided proactively and promptly, good quality early warning and explanation of factors that may affect delivery.	Information provided proactively and promptly, excellent quality early warning and explanation of factors that may affect delivery.
2. User-focus	Very unclear and inaccessible information provided in format not reflecting user priorities or resource constraints.	Unclear, inaccessible or perfunctory provision of information with limited regard for user priorities and resource constraints.	Reasonably clear and accessible information provided with reasonable regard for user priorities and resource constraints.	Very clear and accessible information with good regard for user priorities and resource constraints.	Extremely clear and accessible information with excellent consideration of user priorities and resource constraints.
3. Proportionality	Very little additional information provided for very material changes in capex plan.	Limited additional information provided for material changes in capex plan.	The level of substantiation provided reasonably reflects the materiality of the change under consideration.	Good substantiation for all material changes in capex plan under consideration.	Excellent substantiation for all material changes in capex plan under consideration.
4. Optioneering	Very little information on alternative options presented (including no discussion of opex interactions), no real opportunity for users and IR to scrutinise relative merits of different options.	Limited information on alternative options presented (including limited discussion of opex interactions), limited opportunity for meaningful scrutiny of relative merits of different options by users and IR.	A range of different options identified where possible (including explicit consideration of opex interactions), reasonable opportunities for meaningful user and IR engagement and scrutiny.	Good information provided on alternative options where possible (including explicit consideration of opex interactions), good opportunities for meaningful scrutiny.	Excellent information provided on alternative options where possible (including explicit consideration of opex interactions), extensive opportunities for meaningful scrutiny.
5. Responsiveness	Very limited response to user and IR submissions, does not appear that submissions have been accounted for.	Perfunctory response to user and IR submissions, insufficiently clear how these submissions have been accounted for.	Constructive response to user and IR submissions, reasonably clear explanation of how these submissions have been accounted for.	Engaged and constructive response to user and IR submissions, clear explanation of how these submissions have been meaningfully accounted for.	Engaged and highly constructive response to user and IR submissions, very clear evidence that submissions have been meaningfully accounted for after substantial consideration.
6. Mitigating / corrective actions	Very little evidence of mitigating and/or corrective actions, where appropriate, following user and IR submissions.	Limited evidence of mitigating and/or corrective actions, where appropriate, following user and IR submissions.	In most cases reasonable mitigating and/or corrective actions taken, where appropriate, following user and IR submissions. Actions communicated to stakeholders.	In almost all cases mitigating and/or corrective actions taken promptly, where appropriate, following user and IR submissions. Actions clearly explained to stakeholders.	In all cases mitigating and/or corrective actions taken promptly and proactively, where appropriate, following user and IR submissions. Actions very clearly explained to stakeholders.

Calculating an overall capex engagement score

20. To assess the overall level of performance across criteria and across projects the IR will calculate an overall capex engagement score. To do this it will first calculate an average final score for each project by taking the simple average across the scores for each performance criterion. It will then calculate an overall capex engagement score as the weighted average of project scores, where the weights used are each project's capex value as a proportion of total capex of the projects subject to CAA scrutiny under this incentive.⁵ Figure 2 provides a stylised example for how the overall capex engagement score would be calculated.

Figure 2 Overall Capex Engagement Score Example

Project	Value (£m)	Weight	Timeliness score	User-focus score	Proportionality score	Optioneering score	Responsiveness score	Mitigating actions score	Average project score
1	£10	0.07	2	3	3	2	2	3	2.5
2	£20	0.13	2	3	3	2	3	2	2.5
3	£5	0.03	2	2	3	2	4	3	2.7
4	£15	0.10	3	5	3	1	4	4	3.3
5	£10	0.07	2	4	4	2	4	4	3.3
6	£10	0.07	4	4	2	4	3	4	3.5
7	£20	0.13	3	4	2	1	4	3	2.8
8	£25	0.17	2	4	2	4	2	2	2.7
9	£25	0.17	4	2	3	3	4	2	3.0
10	£10	0.07	2	4	4	3	2	3	3.0
Total	£150								
Weighted Average Overall Capex Engagement Score									2.90

Projects included in the capex engagement assessment

21. There is a question as to which projects are included in the assessment. This could be every individual capex project, a smaller number of programmes (with multiple projects per programme), or a shortlist of projects/programmes which are identified as high priority by airspace users.
22. There are pros and cons to the different approaches. Assessing the quality of NERL's engagement on every individual project could involve a significant regulatory burden. However, including only a shortlist of projects would mean

⁵ We note that over the course of RP3, the value of projects may change – e.g. projects may be dropped or rescoped into larger projects. We discuss this in the next section on process.

that NERL would not be assessed or held to account for the quality of its engagement on all projects.

23. We will engage with NERL and airspace users to agree on the projects to include, and currently have a preference to condense individual projects into a smaller number of larger programmes to be reviewed together. We envisage having a relatively small number of projects/programmes (for example, 10) which collectively represent a large share of NERL's overall total capex. We expect to engage with NERL and users on the projects captured by the incentive when NERL consults on its annual Service and Investment Programme (SIP).

Process and timings

24. In this section we propose more details on the process and timings that would be involved in the assessment of NERL's capex engagement.

Proposed steps

25. The assessment would occur across the whole of the regulatory period. We note that NERL's consultations with airspace users on its capex plan should be continuous and engagement is not restricted to the SIP. The SIP should be viewed as a summary of NERL's consultations. While the SIP would be a natural basis for our assessment, we will consider the quality of NERL's engagement more broadly.
26. The assessment will proceed in the following steps.

Step 1) Initial updates

- NERL will provide us and users with continuous updates on its capex projects/programmes and engage with users and the IR. The regular SIPs, supplemented by quarterly **updates**, will represent a record of NERL's consultations.

Step 2) Initial capex engagement assessment

- At an early stage for each project/programme, the IR will give initial scores for the quality of NERL's engagement, taking account of the views of stakeholders. We can deviate from the IR's score, but if we do so, we will explain why we have done so. We and the IR will work with NERL to make it clear why we have scored its performance as we have and help NERL understand where and how improvements should be made.
- We propose that for each project/programme we would agree with NERL in advance when the initial assessment would take place, noting that projects will be spread out over the course of RP3, and some may continue on into RP4 (which we discuss in more detail below).

Step 3) Further updates

- Taking into account feedback from the IR, airspace users and our initial assessment, NERL will continue to provide us and users with updates on each project/programme and engage with users and the IR.

Step 4) Final capex engagement assessment

- For each project/programme we will agree with NERL in advance when the final assessment should take place, noting that projects will be spread out over the course of RP3. (We discuss in more detail below how we would approach projects/programmes that will continue on into RP4.)

Step 5) Weighted average overall capex engagement score

- Once we have produced a final score for each project/programme we will then calculate the weighted average score across all projects/programmes in line with the approach described above in Figure 2. We presently envisage that steps (5) and (6) would take place at the next price control review.

Step 6) Calculation of penalty (if relevant)

- Based on the final overall capex engagement score a financial penalty may be applied, as described in the next section. This penalty will be increasing with the level of underperformance. The maximum penalty will be capped at a value equal to NERL's return on equity (used in the calculation of NERL's cost of capital in the price control) on its actual capex in the price control period.
- The incentive will be penalty-only. We discuss in more detail in the next section.

Changes to the capex plan within the period

27. The IR will assess the quality of NERL's engagement on its capex plan across a number of projects/programmes. This is important to ensure a sufficiently broad yet proportional appraisal of NERL's capex engagement and in order to identify areas of consistent underperformance. However, we recognise that NERL's capex plan may change over the regulatory period. In fact, this is part of why high-quality engagement is so important. If during the period the value of projects is changed, new projects are added, or projects are discontinued or deferred, it may be appropriate to adjust the weighting of projects in the overall score.
28. When making adjustments to the weighting of projects where the capex plan changes during the period:

- If the budget of a project is reduced or the project is cancelled or deferred, then it is important that NERL is held to account for engaging well with stakeholders on why the decision was made. Therefore, we may not reduce the weighting of such projects or remove them from the assessment but may keep the initial weights as they were. This would ensure that NERL is still held to account.
- If the budget of a project is increased, then it is important that NERL's accountability is also increased. Therefore, in these instances, we may update the value of the project in the weightings. We would then adjust all weightings such that the overall sum of weightings does not exceed 1.

Projects that continue after 2023

29. We recognise that not all of NERL's capex projects planned for 2020-2022 will be delivered during 2020-2022 as some will continue on into RP4. However, we still believe it is appropriate that NERL continues to engage on these projects during 2020-2022 and that it is held to account on the quality of its engagement.

Calculating financial penalties

30. In this section we set out how NERL's capex engagement scores will be used to calculate the level of any penalties.
31. First, we propose that the incentive is penalty-only, meaning that NERL will incur financial penalties if it underperforms, but it would not receive a financial reward if it outperforms. This is in line with the CMA's final report. Nonetheless, we also note that the CMA "*...recommend[s] that the CAA considers ways in which more symmetric incentive arrangements might be applied as part of its RP4 review.*"

Criteria for calculating penalties

32. The level of penalty shall be guided by the following four factors:
1. The severity of the identified failing, and/or of the effects of that failing.
 2. Evidence on NERL's track record: for example, to what extent has the identified failing (and/or similar types of failing) recurred or persisted over time?
 3. Evidence of actions NERL has taken to address the underlying causes of the failing and to guard against their recurrence. This would include the extent to which NERL has adequately responded to past concerns and proposals presented by users and by the IR.
 4. Evidence of actions NERL took to mitigate the effects of the failing.

33. The scoring system we have described above captures these factors:
- by weighting projects/programmes through value this should go some way to ensure that failings on the biggest projects receive most weight (addressing at least in part factor 1);
 - by providing initial scores and retaining a penalty only incentive the incentive will target persistent failures (addressing at least in part factors 2, 3 and 4); and
 - assessment of performance criteria 5 and 6, that capture 'responsiveness' and 'mitigating/corrective actions' (that also go towards factors 3 and 4).

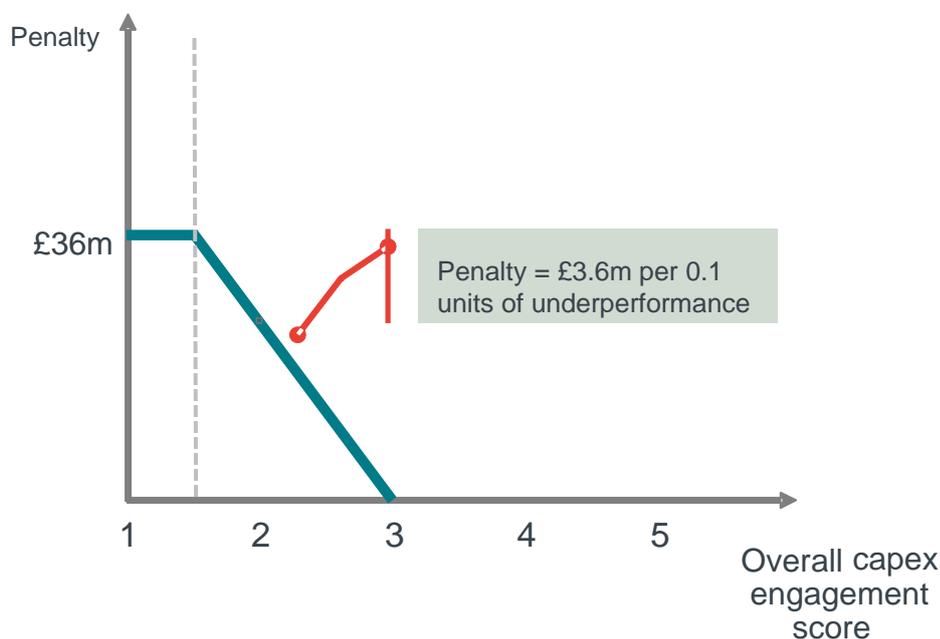
Method for calculating penalties

34. The maximum penalty shall be capped at NERL's rate of return on its actual capex in the price control period⁶. Any penalty will be implemented by either a RAB adjustment or a revenue adjustment at the next price control period.
35. As described above, NERL would receive an initial score and a final score for each of the individual performance criteria for each of the capex projects/programmes included in the assessment. Only the final scores would be used to calculate penalties. Specifically, we will use the Overall Capex Engagement Score, calculated as the weighted average final score across projects, as described above.
36. The penalty will be calculated as follows:
- No penalty will be applied for a weighted average Overall Capex Engagement Score of 3 or above.
 - Penalties will be applied if performance falls below 3. The maximum penalty will be applied if NERL's Overall Capex Engagement Score is 1.5 or below.
 - The level of the penalty increases linearly with the level of underperformance at a rate of 0.1 units of underperformance, up to the penalty cap.
 - Scores will be rounded to the nearest 0.1 decimal.

This is illustrated below.

⁶ This is in line with the way we calculated the £36 million penalty in our proposed licence modifications.

Figure 1 Calculation of the penalty



Conclusions

37. We consider the design set out above should help assess and incentivise the quality of NERL's engagement on its capex plan and is intended to ensure that airspace users are well-informed and listened to. The approach of initial and final assessments, project weightings, the range of criteria, and the calculation of penalties should make the approach reasonable and proportional. It will hold NERL to account for the quality of engagement on its capex plan, while also allowing NERL scope to improve the quality of engagement and avoid penalties.
38. However, it is important that all stakeholders have an opportunity to engage on the details of the proposed mechanism. Areas particularly important for discussion include:
- Assessment criteria – ensuring a common understanding of baseline expectations.
 - Projects to be assessed – views on the subset of capex projects/ programmes that would be included in the assessment.
 - Timings – views on the timing of initial and final assessments, noting that some projects may continue on into RP4.
39. We currently expect to engage with NERL and users when NERL consults on its annual SIP.