

Working note: Capex and Airspace Modernisation Strategy (AMS) funds governance policy development

1. This note provides an overview of policy being developed in respect of RP3 capex and AMS funds governance, intended to inform stakeholder engagement. In due course the CAA will publish the final policy which will inform associated licence conditions and other supporting policy and guidance material where appropriate.

Background

Draft RP3 proposals

2. The CAA's draft proposals for RP3¹ set out the general policy intentions with regard to "enhanced" governance arrangements for NERL during RP3. NERL proposed in its business plan that Service and Investment Plan (SIP) governance, which is used to manage and update their capital programme, could also be used to reach decisions on expenditure from the Opex Flexibility Fund (OFF, described below).
3. Subject to the CAA's strengthening proposals and ensuring proper links with the AMS governance framework, the CAA supports this approach. A summary of the proposed measures to strengthen the capital programme governance arrangements are listed below. Further details on the enhanced SIP process can be found in Annex A:
 - NERL should provide timely and regular updates to airspace users;
 - there will be an escalation process to senior stakeholders if NERL and airspace users cannot agree on a preferred solution;
 - the role of the Independent Reviewer will be enhanced to include assessing NERL's SIP;
 - the Independent Reviewer will report to the CAA and airspace users. Based on Independent Reviewer reports and other information, the CAA will decide whether inefficient spending is not allowed in the regulated asset base (RAB); and
 - if NERL does not provide sufficient information, overspend during RP3 will only be remunerated at its cost of new debt finance (rather than the full weighted average cost of capital (WACC)).
4. The draft RP3 proposals also set out provisions for costs uncertain at the time of adoption of the performance plan, but important to support the delivery of national strategic objectives.
5. The CAA maintained the capex contingency allowance of £34 million proposed by NERL and agreed with airspace users through customer consultation. Use of the allowance will be subject to the enhanced governance process.

¹ [CAP 1758](#) – RP3 Consultation Document (February 2019)

6. The OFF is proposed to hold £35 million (2017 prices) over RP3, and would be similar in nature to the existing RP2 FAS Facilitation (NERL) Fund but broader in scope. The OFF is intended to be the main vehicle to support uncertain costs arising from the implementation of the AMS, although this will not necessarily be its only use. The primary difference between the OFF and the capex contingency allowance that is proposed for RP3 is whether the fund applies to operating or capital expenditure (opex or capex, respectively).
7. In December 2018, the CAA published the UK Airspace Modernisation Strategy (AMS),² setting out the detailed initiatives that industry must deliver to achieve the objectives envisaged in current government policy. NERL will have a key role in supporting the development and implementation of airspace modernisation. It is important to ensure that NERL's governance procedures are properly linked to the wider AMS governance framework.
8. The AMS Support Fund (ASF) of £10 million has been proposed for RP3 with an explicit focus on airspace modernisation over RP3. This would be financed from the CAA's Determined Costs and would be similar in nature to the existing RP2 FAS Facilitation (Small Gaps) Fund, but broader in scope. The ASF is intended to be used for projects that are important to the success of the AMS and where there are no other appropriate mechanisms for the recovery of these costs. This fund will be available to non-NERL third parties only.

Key stakeholders

9. – The key stakeholders for capex and AMS funds will be:
 - a) NERL which is responsible for its opex and capex and has been commissioned to set up, finance and manage the Airspace Change Organising Group (ACOG) to produce the UK airspace change masterplan, and to propose airspace change proposals (ACPs);
 - b) Airspace users (primarily commercial airlines), which use and pay for NERL's air traffic services, but also general aviation and the military, who interact with NERL's services and have an interest in AMS;
 - c) Airports which are reliant on NERL's air traffic services to allow aircraft to fly to and from the airport, and have responsibility for lower altitude ACPs in their vicinity;
 - d) CAA as the safety, airspace and economic regulator of NERL;
 - e) The CAA's Delivery Monitoring and Oversight function (DMO) which acts as the gateway between AMS delivery groups and co-sponsors, and will monitor risks and oversee delivery of the AMS; and
 - f) AMS co-sponsors, the Department for Transport and CAA who jointly sponsor the AMS.

² [CAP 1711](#) - Airspace Modernisation Strategy (December 2018)

Change governance cases

10. The governance framework must outline the appropriate procedures and stakeholders involved under a variety of circumstances. This section identifies three ‘cases’ which may result; the process and form of governance used will depend on the form of change in delivery that is being proposed.

Business as usual (non-AMS)

11. Activities that (1) are not related to the AMS, and (2) would typically be considered part of NERL’s business as usual will be considered in this first change governance case. Since NERL is accountable for its capital programme, activities that fall under this case would be governed by the enhanced SIP process. This process will be led by NERL.
12. As the ultimate manager of its own spending, NERL will retain the final decision-making ability on activities in this case, following engagement with stakeholders through the enhanced SIP process. However, the CAA will be able to express a view, and signal as to whether given expenditure is appropriate. In the case of capital expenditure, this could for example signal whether a given activity might not be included in the RAB.
13. The Independent Reviewer could have a role in supporting and informing airspace users and the CAA views stemming from the NERL consultation process.

Business as usual (AMS-related)

14. Activities that (1) support the implementation of the AMS, and (2) would typically be considered part of NERL’s business as usual are considered as part of the second change governance case.
15. Such activities would still be governed through the enhanced SIP process. However, the wider AMS governance structure will need to have suitable oversight. Decisions that require input from the wider AMS governance framework would be taken by the AMS co-sponsors (Department for Transport and the CAA), following advice from the DMO. The extent of involvement will necessarily depend on the circumstances, but could range from ensuring the DMO is kept informed as an observer of the SIP process, to the co-sponsors proactively expressing a view on proposed activities, or playing a key role in escalation procedures should NERL and airspace users not arrive at a solution.
16. There will also be scope for the DMO to engage early in the process, including in the determination of which activities are considered to be related to the AMS. At that stage, the DMO will also have the opportunity to ‘champion’ activities through the remaining process should the activity be deemed suitably important for the delivery of AMS.
17. Activities that have been initiated due to a third party’s requirement as part of the AMS may still be eligible to be considered as part of this change governance case (and be eligible for

OFF consideration). For this to be the case, projects would typically need to be delivered or sponsored through the OFF eligibility process by NERL on behalf of the third party.

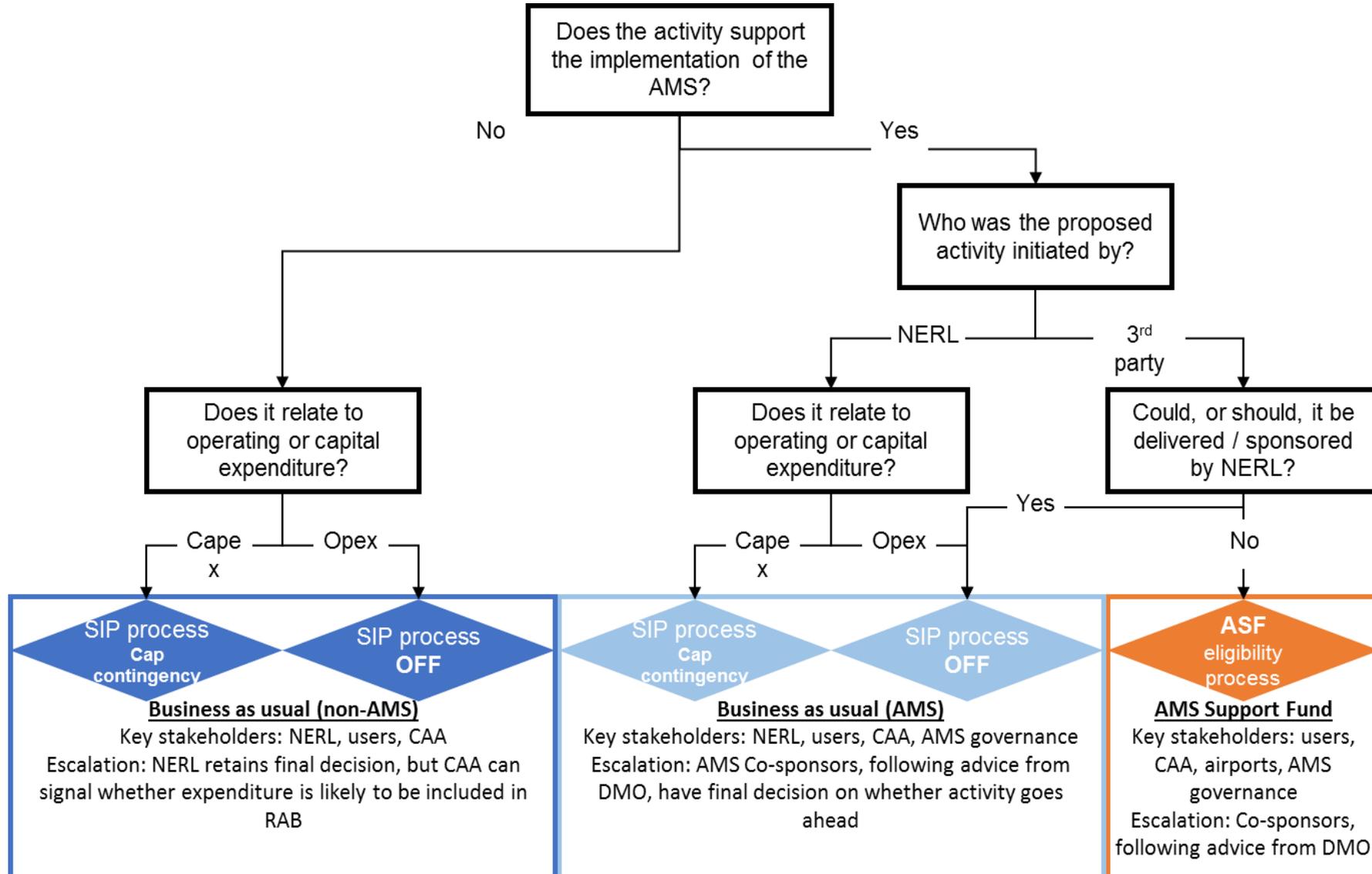
AMS Support Fund

18. The third change governance case is when there are activities that (1) support the implementation of the AMS, but (2) have been initiated by a third party and could not appropriately be delivered or sponsored by NERL. In this case, the activity could be considered for funding through the ASF. A key eligibility criterion for this fund would be evidence that the project sponsors have exhausted all other avenues of funding.
19. The ASF could maintain a governance structure similar to the existing RP2 FAS Investment Board, led by the CAA. The AMS co-sponsors would engage in this process and provide a view where necessary, informed by guidance from the DMO.
20. The Investment Board could fulfil the need for an objective review of potential investment proposals to the ASF and comprise of parties with interest in the equitability of decisions across the AMS deployment stakeholders, including airlines, general aviation, airports, air navigation service providers, Ministry of Defence and wider industry through the Industry Communications for the Airspace Modernisation Strategy (ICAMS). The AMS co-sponsors could also seek to input into and steer funding decisions to ensure the AMS is being delivered.
21. The types of questions the Investment Board could consider in their deliberations, might include:
 - a) Does the financial commitment requested fall within the ASF budget capability?
 - b) Does the proposal have cross industry support and meet AMS Strategic Guidance criteria?
 - c) Have other financial support options been considered, i.e. European or Government funding?
 - d) Do the objectives of the proposal align with the strategic aims of AMS and the research or implementation that supports AMS deployment?
 - e) Does the scope seem achievable given resources, timings and budget described?
 - f) Are the benefits described identifiable and measurable?
22. As in the NERL business as usual (AMS) case, there will also be scope for the DMO to engage early in the process, including in the determination of which activities are considered to be related to the AMS. At that stage, the DMO will also have the opportunity to 'champion' activities through the remaining process should the activity be deemed suitably important for the delivery of AMS.

Decision tree

23. Figure 1 shows the decision tree used to determine what the appropriate governance process should be.

Figure 1: Decision tree showing determination of appropriate governance case



Key risks

Timing of spending of money

24. A key risk for these funds is that money is not released at the correct time in RP3. Worthy projects may not receive funding early in the reference period due to the potential for there being even more beneficial projects in the future, leading to a surplus of funding if future projects do not materialise. Conversely, large expenditures early on could prevent future worthy projects.
25. In order to mitigate this risk, the eligibility processes for the funds will need to account for this. Projects may need to be prioritised before funding is released, with each project ultimately funded demonstrating it is of a clear value and that the case for it is well-evidenced.
26. One possibility that may be worth exploring further would be to introduce an annual forward-looking plan of activities that are expected to seek funding from each of the three funds in the next 12-month period. This could either be in the form of a forward plan, produced by either NERL or the AMS Investment Board, or via a call for “tenders” from external stakeholders. Stakeholders could then use this to inform expectations for the NERL or CAA processes in the medium term and to inform the prioritisation of available funds.

Unintentional transfer of accountability

27. Another key risk is that the involvement of other parties in the governance process, particularly for AMS, may blunt the incentive for NERL (as the provider of en route and London Approach air traffic services, and sponsor of ACPs) and airports (also as a sponsor of ACPs) to take responsibility and accountability for their expenditure and decision making.
28. The capacity and environmental targets in the performance plan will provide an incentive on NERL to provide a given level of service, as otherwise they could pay financial penalties. This helps to mitigate against NERL failing to invest sufficiently to maintain service levels. On airspace change, the Government’s Green Paper on Aviation Strategy is consulting on the prospect of new legislation which would require NERL to take forward ACPs, both for airspace for which it is responsible, and, possibly in, lower level airspace where an airport does not propose an ACP for airspace in its area which had been identified for airspace change in the masterplan. This could mitigate against the risk of stakeholders being unwilling to make ACPs where they are required for the proper development of the network.

Classification of costs

29. NERL could have an incentive to categorise spending as related to airspace modernisation. This is a high priority area and it is, therefore, more likely that spending will be allowed (for example, the CAA’s draft RP3 performance plan proposals did not apply an efficiency

adjustment to airspace modernisation capex but did apply an adjustment to other capex). The influence of airspace users is also diluted by other stakeholders (who will have objectives other than cost efficiency).

30. Additionally, current proposals are for any funds from the OFF or AMS support fund that are not utilised will be returned to users in future reference periods. Therefore, there is an overarching incentive for NERL (or project sponsors more generally) to use as much of these funds as possible. There is a risk that this incentive would lead to stakeholders using a fund for projects that need not be funded specifically from that fund, in turn making less money available for more relevant projects.

Outstanding issues

31. There are a number of other areas/issues where policy thinking is in early development. A non-exhaustive list is outlined, as work in progress, below:

Role of the Independent Reviewer (IR)

32. The current role of the IR is to “review the accuracy of the Licensee’s reporting”. In practice, the IR has been taking a more active role in assessing the quality of NERL’s reporting more generally, and this has led to positive developments, for example on reporting risk management. NERL’s business plan supported an enhanced role for the IR, and the CAA’s RP3 draft proposals also included expanding the IR’s role to include assessing how well NERL has explained and justified its capital programme in its SIP, as well as reviewing its reporting.
33. This will help support stakeholder understanding of NERL’s capital programme. Airspace users have noted that it can be challenging for them to effectively assess the efficiency of NERL capital expenditure. NERL spending on, for example, IT infrastructure can differ significantly from that typical for airlines, and is often made of bespoke projects, making it difficult to benchmark.
34. In the context of capex governance at Heathrow airport, the appointment of an Independent Funds Surveyor (IFS) has had a positive reception. The IFS has played an important role in giving airlines more confidence in the capex governance process, and has allowed more transparency and clarity in the process.³

³ The IFS is jointly appointed by the airlines and Heathrow Airport to provide support in the capex governance process. It reviews and reports on the reasonableness of key investment decisions. This was modelled on the role of a monitoring surveyor in commercial property and aimed at providing assurance that capex is invested efficiently. More detail can be found in [CAP1563e](#) - Review of Heathrow Airport’s Q6 Capex Governance, CEPA (June 2017)

35. An enhanced role for the IR could provide a similar role for NERL's capital programme – noting the need to adopt a proportionate approach, the IR's scope would likely be less broad compared to the IFS. Even if the IR was not ultimately put in a position to reach views on the efficacy of expenditure, regular reports by the IR would likely be a key input into the CAA's ex-post efficiency review. Therefore, stakeholders would be able to take IR reports as a signal on whether, for example, certain capital spending is likely to be allowed as part of the RAB.

Capex incentives on NERL

36. We will be undertaking an efficiency review of NERL's RP2 capex early in RP3. In the event the review identifies any expenditure as inefficient, we may decide to disallow it by making a downwards adjustment to NERL's starting RAB for RP4.

37. For RP3, to encourage the provision of high quality information as part of capex engagement, under the enhanced SIP process, we are considering a financial incentive on NERL, such that if there are significant weaknesses in NERL's ongoing provision of information on its capital spending, then any overspend during RP3 would only be remunerated at its cost of new debt finance (rather than the full weighted average cost of capital WACC), even if it subsequently passes an efficiency test.

Draft eligibility criteria

38. In order for an activity (including third party activities delivered or sponsored by NERL) to be eligible for funding through the OFF or capex contingency, NERL would have to adequately demonstrate, as a minimum, that:

- the activity is supported by NERL's customers and, where appropriate, wider AMS governance bodies;
- any additional expenditure is based on unforeseen additional scope rather than cost overruns and is a necessary requirement to deliver benefits to airspace users; and
- the activity has a strong business case, demonstrating the project is well costed and would benefit users, with a clear and established evidence base to support both cost and benefit forecasts. This is particularly true if the project is not directly related to the implementation of the AMS.

39. In order for an activity to be eligible for funding through the ASF, project sponsors would have to adequately demonstrate, as a minimum, that:

- the activity and any related expenditure are supported by users paying the charges and/or by wider AMS governance;

- the project enables the realisation of AMS benefits and is not reasonably considered business as usual (for either NERL or the relevant third party);
- no other potential sources of funding are available – for example, evidence that grants and loans from government of Transport Catapult initiatives have been exhausted;
- there is insufficient value to key third parties to justify their investment, such that without the support fund no third parties would be willing to invest in the activity.

Next steps

40. Stakeholders wishing to comment on the proposals in this working document, or related matters, are encouraged to send them to matt.claydon@caa.co.uk and rod.gander@caa.co.uk.
41. In particular, we welcome stakeholders views on new/alternative concepts that could support enhanced governance for capex and AMS funds.
42. In the meantime, we will continue to develop the concepts and procedures outlined above as we prepare our final RP3 proposals for the summer. Final policy and guidance and, where appropriate, associated NERL licence conditions, will be published before the start of RP3 in January 2020.

Annex A: The Enhanced SIP process

43. Condition 10(3) of NERL's Licence requires the company to prepare a SIP that refers to the most recent business plan and the related airspace and technology programmes each year. This must provide an update of investment plans, delivery against programme milestones and any material change in NERL's expectations regarding services or investment plans. The development of the SIP must be consulted on with users and reasonably approved by the CAA. The current role of the IR is to "review the accuracy of the Licensee's reporting".
44. While there is general agreement that the current SIP process works reasonably well, all stakeholders have previously agreed it could be improved.⁴ During its RP3 consultation, NERL consulted customers on enhancements to the SIP process:
- Agreeing key level zero milestones or other milestones with customers at the annual full SIP meeting. These are to be tracked under the SIP process, without removing the requirement for overall SIP reporting of total Capex plan
 - NERL will track these milestones and use the following principles to engage with customers if there are changes:
 - Safety: Advise customers and CAA if immediate change required;
 - Small: changes to implementation plan that do not affect 'key' milestones, NERL will provide an update at next SIP;
 - Medium: changes to key milestones incorporating either a 10% change in costs (that cannot be saved elsewhere in the portfolio), 10% changes in benefits (scale or timescale), or three months change to a key milestone. In such cases NERL, would update through an ad-hoc meeting.
 - Large: if there are material or fundamental changes to the key milestones, scopes, benefits, or delivery of a project. NERL would expect to hold a face-to-face update with customers with a formal options review before making a decision.
 - NERL's proposed escalation process involved a first stage of a SIP Taskforce investigating recommendations and options. A second stage would escalate to senior stakeholders (potentially including DfT and wider AMS governance structure if related to airspace), airlines, and other stakeholders (e.g. airports) depending on subject.
45. The CAA generally supports NERL's approach, subject to a number of strengthening conditions being satisfied. As set out in the draft proposals for RP3, the CAA took into account NERL and stakeholder views, and the recommendations of the Independent reviewer when proposing the following strengthening conditions:

⁴ Chase Partners Limited (January 2019) 'NERL SIP: Review of SIP Process – Independent Reviewer Report', available at www.caa.co.uk/natslicence, pg. 2

- NERL to provide airspace users with timely and regular updates on its approach to options appraisal, before it makes its final decisions to commit to major projects;
- if NERL and airspace users cannot agree on a preferred option, an escalation process to senior stakeholders (including the CAA, DfT (if related to airspace), airports (dependent on subject) and airlines) would be triggered;
- the role of the Independent Reviewer to be enhanced to include assessing how well NERL has explained and justified its capital programme in its SIP, as well as reviewing its reporting;
- the Independent Reviewer will report both to the CAA and airspace users, and these reports will (inter alia) inform the CAA's decision on whether capital spending should be allowed in the RAB following its ex-post reviews of capital efficiency. Adjustments would be made in the reference period following that in which the spending has been incurred. If NERL does not provide persuasive evidence that spending has been efficiently incurred the CAA may exclude such spending from its RAB; and
- if there are significant weaknesses in NERL's ongoing provision of information on its capital spending then any overspend during RP3 will only be remunerated at its cost of new debt finance (rather than the full WACC) during RP3, even if it subsequently passes an efficiency test. As noted above inefficient spending may not be added to the RAB.