



5th Floor South
Brettenham House
Lancaster Place
London, WC2E 7EN

By email: Rod.Gander@caa.co.uk

21 October 2020

Dear Rod,

NERL response to CAA consultation on Licence modifications and guidance for 2020-2022 (CAP 1967)

1. Thank you for consulting us on your changes to our Licence and your guidance to implement NERL price controls for the period 2020-2022. This letter does not repeat all facts and representations that we have already made to you as part of your Reference Period 3 (RP3) price control decision process or to the Competition and Markets Authority (CMA) as part of the subsequent reference. Instead, it focuses on the areas that remain relevant and important to NERL. These are:
 - **CMA's Final Determination for 2020** – including a practical mechanism for implementing these changes in the Licence now
 - **Engagement incentive clarity** – more information in the CAA's guidance about the process, including setting the assessment criteria upfront and a clear description of how the penalties will be applied
 - **Timescales for capex governance feedback** – the success of the new capex governance regime will depend on the timeliness of feedback from the Independent Reviewer and the CAA
 - **Drafting improvements** – NERL has previously made a number of technical suggestions to improve the drafting of the text and the longevity of the Licence
2. More detailed comments are attached in Appendix A with references to the relevant paragraphs of CAP 1967.

CMA Final Determination for 2020

3. The CMA's Final Determination (FD) applies for 2020-2022, but the unit rates for 2020 were set in 2019, based on the CAA's RP3 decision. The CAA has updated the unit rates in the Licence based on the CMA's FD, but there is no explanation provided in the Licence on how the revised revenue associated with the new unit rates for 2020 will be treated. The CAA stated in its consultation document CAP 1967 that it intends to enable NERL to recover the revenue

difference for 2020 through its RP3 review¹. However, we believe that including these adjustments in the Licence for 2020 in the unit rates for 2021 (or even 2022) will be the clearest way of establishing this intention for all stakeholders. If not, the CMA FD is not reflected in full in the Licence. We consider the Licence needs to establish a clear baseline on which future consultations can be based.

Engagement incentive clarity

4. The CAA is not constraining its assessment criteria to those set out in its guidance for the engagement incentive, in the same way that it has stated it intends to for the efficiency incentive. It is not clear to us why the CAA is not doing this, in particular given the significant sums at stake of up to c. £36m. For example, we are not clear what facts the CAA is referring to at the end of paragraph 6 on page 74, which states the CAA “may adopt a different approach if the facts of an individual case reasonably justify it”, which is different to its proposal to the CMA. NERL requests that the CAA provides a clear list of the facts that it would take into consideration for not applying the engagement incentive guidance. The lack of a clear list of facts could lead to less engagement which is the opposite outcome to what the CAA, customers and NERL want to achieve.
5. In addition, in order to define more clearly the potential penalty, it would be helpful if the guidance could clarify the following points:
 - Relevant capex – we assume this is only capex begun after 1 January 2021, after the relevant Licence conditions have been made and the Independent Reviewer appointed, but we request that the CAA clarifies this in its guidance
 - A RAB adjustment – we assume that any penalty would be implemented via a RAB adjustment in the same way as DIWE, but we request that the CAA clarifies this in its guidance
 - Score rounding – the CAA’s guidance should clarify the rounding which it intends to apply in the measurement of engagement performance on each project, and then the aggregation of project scores to derive the overall RP3 portfolio score on which any penalty would be based. This guidance in advance would help to prevent unnecessary debates between CAA, NERL and customers later. As the penalty rises in steps of up to £2.4m for each 0.1 in units of under-performance, the method of score rounding could be material to the actual penalty incurred.

Timeliness of feedback

6. The timeliness of feedback from the Independent Reviewer and assessment of the CAA will be a crucial factor in the success of the new capex governance regime. This feedback should be delivered as soon as practicable to enable NERL to respond promptly to any identified shortfalls in performance in the remaining life of that project (and to apply any wider lessons

¹ CAA 2020, Economic regulation of NATS (En Route) plc: Consultation on Licence modifications and guidance: CAP 1967, p. 11

to other capex programmes). While this would always be true, it is especially the case given recent airline feedback and CAA delays in providing feedback to NERL on the SIP during RP2.

7. Airlines emphasised to us last month that they will not have the expertise or manpower to engage as fully in the SIP as they or we would like, given the unprecedented crisis the aviation sector finds itself in. Since H1 2018, no SIP has received CAA approval for its form, scope and level of detail. We are still waiting for CAA feedback on the SIPs we have submitted since the end of last year (see Table 1 below).

Table 1: NERL and CAA track record on SIPs during RP2

SIP version	NERL Submission	CAA		
		Feedback	Approval	Turnaround
SIP15	27/02/2015	18/09/2015	✓	c. 7 months
SIP16	18/12/2015	01/06/2016	✓	c. 2 weeks
SIP17	23/12/2016	26/01/2017	✓*	c. 4 weeks
iSIP17	30/06/2017	18/08/2017	✓	c. 6 weeks
SIP18	21/12/2017	18/03/2018	✓	c. 3 months
iSIP18	29/06/2018	03/10/2018	✓	c. 3 months
SIP19	20/12/2018	28/03/2019 22/05/2019	✗	c. 3 months
iSIP19	28/06/2019	10/10/2019	✗	c. 4 months
SIP20	20/12/2019	✗	✗	c.10 months
iSIP20	30/06/2020	✗	✗	c. 4 months

* Apart from SIP16, the CAA provided its approval (or withheld its approval) as part of its feedback. For SIP16, approval was given six months later on 28 July 2017 in response to NERL addressing the CAA's earlier feedback.

8. This recent track record is problematic given the new heightened governance regime the CAA put in place for capex and the SIP from 1 January 2017, with its additional resource burden on customers and NERL. This will be exacerbated by the governance regime being enhanced again, with the breadth of the CAA's assessment significantly expanded beyond its current criteria of scope, form and level of detail.
9. Given the scale of the challenges we and the wider sector face, with NERL's simple average capex spend per day in excess of £0.3m, we request a two-week turnaround commitment by the Independent Reviewer (from completing an initial assessment of NERL's customer engagement on a project) and 30 days by the CAA for initial views. We believe that these commitments would be reasonable, given the size of the financial penalties at stake and the efforts by all stakeholders to set up and participate in the CMA's recommendations for an enhanced capex governance regime.

Drafting improvements

10. We have made a number of drafting suggestions previously to Brexit-proof the Licence and make definitions more consistent with what happens in practice, e.g. redrafting instead of removing Condition 5 paragraph 29 on operating leases. If the CAA has considered these suggestions and rejected them, we would appreciate understanding the rationale behind the decisions.
11. We also do not see why referencing the ESO regime is relevant on page 76 as the scheme proposed by the CAA is materially different and such reference could lead to confusion. We also note stakeholders have already considered this reference as part of CAA's response to CMA's provisional findings. Therefore, we suggest it is removed from the guidance.
12. Please do not hesitate to get in touch, should you require clarification on any of these points.

Yours sincerely,



Mihai Lulea
Economic Regulation Manager

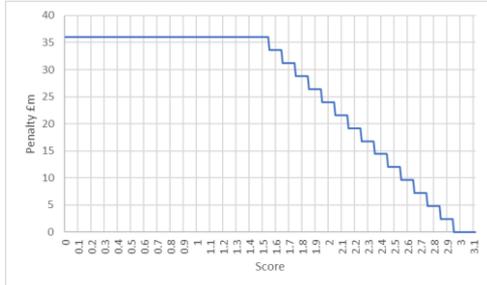
Cc: Matt Claydon, CAA ERG
Bronwyn Fraser, CAA ERG
Alistair Borthwick, NERL
Richard Churchill-Coleman, NERL
Thea Hutchinson, NERL

Appendix A – Detailed comments

Reference	Area	Feedback	Suggestion
Para 9, p. 59	Condition 22, Other Licence conditions	ADS-B measures yet to be agreed with customers and the CAA, therefore it is unclear exactly what benefits will form part of the independent review and whether they will be able to be converted into costs (e.g. increased safety).	<p><i>By no later than two years and six months after the licensee has certified it is operating a fully ADS-B based service in the En route (Oceanic) Area, or at a later date agreed with the CAA, the Licensee shall commission an independent review of [its performance against the measures agreed with customers and the CAA] whether the benefits of providing a fully ADS-B based service outweigh the costs of providing the service.</i></p> <p>Please note any changes to para 9, page 59 would need to be reflected in para 9, page 19.</p>
p. 67	Minor Licence modifications to improve clarity	NERL agreed with the CAA that para 29 on page 39 of Condition 5 on operating leases is out of date. However, it disagreed with the CAA removing it and asked for it to be rephrased instead. We consider that certain elements of it remain relevant and should be retained, otherwise, there is a risk to misinterpret the way Financial Indebtedness is treated.	NERL asks the CAA to explain why it rejected NERL's proposal and to reconsider adding the rephrased paragraph for clarity. Suggested wording: <i>"The CAA's definition of Financial Indebtedness does not include lease liabilities which have been recognised since 1 April 2019 by the Licence holder as a result of an amendment to the accounting treatment of operating leases by the relevant accounting body and which are generally classified as debt."</i>
Para 7, p. 69	DIWE introduction	Unclear how the CAA will take a decision if there is a lack of consensus amongst customers.	Add a paragraph to clearly explain how the CAA will take a decision if there is a lack of consensus amongst customers.
p. 73	Overall - Capex engagement incentive	NERL assumes relevant capex is only capex begun after 1 January 2021, after the relevant CMA Licence modifications have been made and the Independent Reviewer appointed.	Add a footnote or paragraph to the guidance to clarify. Suggested wording: <i>"Capex refers to capex begun after 1 January 2021 after the relevant CMA Licence conditions have been changed and the Independent Reviewer appointed."</i>

Para 6, p.74	Engagement incentive guidance	Unclear what facts the CAA is referring to at the end of the paragraph which states the CAA “may adopt a different approach if the <i>facts</i> of an individual case reasonably justify it”. NERL also notes this paragraph is new and was not submitted to the CMA before.	Add a paragraph clearly stating what facts the CAA would take into account when deciding to adopt a different approach to the engagement incentive guidance. This would provide NERL with increased certainty to help manage regulatory risk and is consistent with best practice.
Para 13, p. 76	ESO reporting and incentive arrangements	The references should be removed as not relevant since the details of the CAA scheme differ materially in principle and practice from those adopted by Ofgem for ESO. If kept, these could cause confusion as to how the CAA will apply scoring to NERL.	Remove blue box with references to the ESO/ Ofgem arrangements.
Para 17, p. 77	Publication of IR initial scoring for NERL engagement performance	Given the quarterly nature of NERL’s submissions (biannual SIP and quarterly dashboards), we would be grateful for publication two weeks after submission so that we can reflect properly in next iteration.	<i>We will publish the IR’s scores [two weeks after NERL’s submission].</i>
Para 18, p. 77 and para 39, p. 84	Publication of CAA’s initial assessment	Paragraphs seem to suggest that will happen only once a year. But this is not timely enough, especially if there is a difference between the CAA’s and IR’s views, particularly when these new processes are bedding in.	<i>We will take account of the findings of the IR and representations from stakeholders (including NERL) in forming our assessment [which we will publish on our website 30 days after NERL’s submission]</i>
Para 18, p. 77	Scoring system for assessment	NERL’s right to appeal comes at the following price control review at	<i>Nonetheless, the final penalty (if any) will be calculated and applied at the following price control review. [NERL will have the opportunity</i>

		the same point at which we are informed of the penalty. We consider a more reasonable approach would be to allow an initial appeal at the point at which the scoring is done.	<i>to an initial appeal when the scoring is done or when the final penalty (if any) is calculated] (in addition to its procedural rights to judicial review).</i>
Footnote 21, p. 77	Capex performance	We consider the footnote an important paragraph for project definition and therefore it should be in the main body of the document.	Move footnote into the main body of the document.
Figure 1, p.78	Guidance on scoring	Unclear what constitutes 'reasonable' on the target score of 3 and how will the scoring be applied.	Define what 'reasonable' means on the target score of 3 and if the Independent Reviewer will take a poll of all stakeholders involved in the consultation or is it their judgement plus the CAA arbitration of such score that determines the outcome.
Para 22, p. 79	Calculating an overall capex engagement score	Paragraph refers to "total capex". It is not clear that this refers to the total capex of the projects/ programmes subject to CAA scrutiny, not total capex planned/ delivered during the reference period.	Change "total capex" into <i>"the total capex of the projects subject to CAA scrutiny under this engagement incentive"</i>
Paras 32, 33, p. 82	Calculating financial penalties for capex engagement	Criteria for calculating penalties are a reproduction of what has already been set in para 8, p. 75. Unclear what is the reason for mentioning the criteria twice.	Remove paras 32 and 33 p. 82 and make reference to para 8, p. 75 instead where the criteria were already set.
Para 36, p.83	Method for calculating penalties for capex engagement	It is unclear how the penalty will be paid by NERL, the CAA should specify here. NERL's expectation is that this will be similar to the DIWE test, meaning any penalty will be deducted from the RAB at the start of next reference period.	<i>"The penalty will be deducted from NERL's RAB at the start of the next reference period".</i>

<p>Para 36, p.83</p>	<p>Method for calculating penalties for capex engagement</p>	<p>It is unclear how the calculation will work in practice, including the application of decimal places since the penalty will increase in steps for each score of 0.1 below 3, and not rise smoothly. For example, a score of 2.95 rounds to 3.0 (to the nearest 0.1), hence no penalty, but a score of 2.94 rounds to 2.9, hence penalty of £3.6m.</p>	<p><i>"The score will be rounded to the nearest 0.1 decimal"</i></p>																																																																		
<p>Figure 2, p. 84</p>	<p>Method for calculating penalties for capex engagement</p>	<p>Figure 2 needs updating as it currently illustrates CAA's previous proposal where penalty maxes out at score of 2 which is no longer the case.</p>	<p>Change Figure 2 into:</p>  <table border="1"> <caption>Approximate data points from the updated Figure 2 graph</caption> <thead> <tr> <th>Score</th> <th>Penalty (£m)</th> </tr> </thead> <tbody> <tr><td>0.0</td><td>36.5</td></tr> <tr><td>0.1</td><td>36.5</td></tr> <tr><td>0.2</td><td>36.5</td></tr> <tr><td>0.3</td><td>36.5</td></tr> <tr><td>0.4</td><td>36.5</td></tr> <tr><td>0.5</td><td>36.5</td></tr> <tr><td>0.6</td><td>36.5</td></tr> <tr><td>0.7</td><td>36.5</td></tr> <tr><td>0.8</td><td>36.5</td></tr> <tr><td>0.9</td><td>36.5</td></tr> <tr><td>1.0</td><td>36.5</td></tr> <tr><td>1.1</td><td>36.5</td></tr> <tr><td>1.2</td><td>36.5</td></tr> <tr><td>1.3</td><td>36.5</td></tr> <tr><td>1.4</td><td>36.5</td></tr> <tr><td>1.5</td><td>36.5</td></tr> <tr><td>1.6</td><td>35.5</td></tr> <tr><td>1.7</td><td>34.5</td></tr> <tr><td>1.8</td><td>33.5</td></tr> <tr><td>1.9</td><td>32.5</td></tr> <tr><td>2.0</td><td>31.5</td></tr> <tr><td>2.1</td><td>30.5</td></tr> <tr><td>2.2</td><td>29.5</td></tr> <tr><td>2.3</td><td>28.5</td></tr> <tr><td>2.4</td><td>27.5</td></tr> <tr><td>2.5</td><td>26.5</td></tr> <tr><td>2.6</td><td>25.5</td></tr> <tr><td>2.7</td><td>24.5</td></tr> <tr><td>2.8</td><td>23.5</td></tr> <tr><td>2.9</td><td>22.5</td></tr> <tr><td>3.0</td><td>21.5</td></tr> <tr><td>3.1</td><td>0</td></tr> </tbody> </table>	Score	Penalty (£m)	0.0	36.5	0.1	36.5	0.2	36.5	0.3	36.5	0.4	36.5	0.5	36.5	0.6	36.5	0.7	36.5	0.8	36.5	0.9	36.5	1.0	36.5	1.1	36.5	1.2	36.5	1.3	36.5	1.4	36.5	1.5	36.5	1.6	35.5	1.7	34.5	1.8	33.5	1.9	32.5	2.0	31.5	2.1	30.5	2.2	29.5	2.3	28.5	2.4	27.5	2.5	26.5	2.6	25.5	2.7	24.5	2.8	23.5	2.9	22.5	3.0	21.5	3.1	0
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