Consumers and Markets Group

Economic regulation of NATS (En Route) plc: consultation on approach to the next price controls review

CAP 1994

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About this document

This document sets out the key issues and seeks stakeholder views on the approach to the economic regulation of NATS (En Route) plc (NERL) in light of the impact of the Covid-19 pandemic. The Competition and Market Authority's (CMA) report and determination, following the proposals of the CAA, established price controls for NERL for the period 2020 to 2022. However, in light of the Covid-19 pandemic, the CMA agreed that the CAA should review the regulatory arrangements once there was better information about the path to recovery from the pandemic. This document provides our initial views and proposes next steps for consultation.

The document sets out:

- the short-term and longer-term policy challenges that we will need to address in developing the regulatory framework for NERL;
- policy options for addressing these challenges; and
- the timetable and processes we will need to follow to have new price controls in place in a timely manner.

Views invited

We welcome views on all the issues raised in this document and, in particular, the questions highlighted in chapters 1 to 3 and Appendices C and D.

Please e-mail responses to economicregulation@caa.co.uk by no later than 12 January 2021. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 102 of the Transport Act 2000 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Matt Claydon (matt.claydon@caa.co.uk).

Summary and introduction

Introduction

1. NERL[1] is subject to price controls that set the maximum charges that it can recover from airspace users for the provision of air traffic services (ATS) for its Eurocontrol en route, London Approach and Oceanic en route services.

2. We last made price control determinations on NERL's charges for Reference Period 3 (RP3) in 2019, which were intended to cover the period from 2020 until 2024. In making our RP3 decisions, as well as setting maximum charges, service quality targets and incentives, we also introduced enhanced capital expenditure (capex) governance arrangements and incentives. We also set out roles for NERL in supporting the Airspace Change Organising Group (ACOG) and creation of an airspace design masterplan for the UK.

3. NERL rejected our RP3 decisions and the determination was referred to the Competition and Markets Authority (CMA) to resolve. During the period when the CMA was considering the reference, Covid-19 emerged as a global pandemic, with the resulting severe and unprecedented downturn across the aviation sector. Air traffic volumes in April 2020 were approximately 90% below April 2019 volumes. There has been a modest, but variable recovery since then. In August 2020, flights were approximately 60% lower than the previous year, however by October 2020 this had fallen to approximately 65% lower than the previous year.[2] Recent developments with vaccines provide stronger prospects for recovery in 2021, but there remains a significant degree of uncertainty about how any recovery will develop.

4. In reviewing our RP3 decisions early in 2020, the CMA decided that the impact of Covid-19 would be too difficult to properly assess as part of its determination and that we should review these matters when better information was available.

[1] Abbreviations used in this consultation as well as references to previous CAA consultations are set out in Appendix A.

[2] Source: Network Manager, Eurocontrol.

The CMA established price controls covering the period January 2020 to December 2022, on the expectation that this would give the CAA enough time to set new controls and take into account a greater understanding of the impact of the Covid-19 pandemic and the path of recovery, but the CMA was clear that the CAA should bring forward new price controls sooner if appropriate. The CMA also set out an expectation that a reconciliation exercise would be necessary for 2020 and 2021 with reference to actual flight volumes and costs over the period since the start of 2020. The CMA made its final report in July 2020 and, subject to the statutory process, we expect the associated licence modifications to be in force before the end of 2020.[3]

5. Overall, the CMA determination made a number of changes to NERL's capital expenditure incentives and allowed NERL about a further £34 million over the period 2020 to 2022, which represents a 1.8% increase compared to our original decisions, in respect of the main en route price control.[4] The majority of the difference relates to an additional £14 million in respect of non-regulated income and an increase in the pre-tax weighted cost of capital (WACC) allowance from 2.91% to 3.48%, worth about £19 million.

Key issues

6. Our approach to the regulation of NERL will continue to be driven by our duties under the Transport Act 2000 ("TA00"). Consistent with our primary duty, our overriding priority will be to take the steps necessary to support NERL in maintaining a high standard of safety in the provision of ATS. We must also exercise our ATS functions in a manner we think are best calculated to protect and further consumers' interests, and promote economy and efficiency on the part of NERL – for ease, we sometimes refer to these duties collectively as "affordability and protecting consumers' interests" in this consultation. Our duties also require that we secure that NERL does not find it unduly difficult to finance

3 See the CAA's CAP1967 consultation on proposed modifications to NERL's licence conditions, Sept 2020: http://publicapps.caa.co.uk/docs/33/Economic%20regulation%20of%20NATS%20(En%20Route)%20plc%20(CAP1967).pdf

4 Based on data in Table F1, Appendix F. CMA final report on NATS (En Route) Plc/CAA Regulatory Appeal.

its licensed activities as set out in the TA00. Appendix B of this consultation sets out our duties in full.

7. We emphasise affordability to recognise that part of the interests of users are served by NERL's charges being at a level that supports users in re-establishing and operating services, given the difficult circumstances created by Covid-19. Beyond this broad concept we have not yet crystallised a clear definition of affordability, but it seems unlikely in the difficult circumstances of Covid-19 we will be able to rely on a simple definition of affordability (such as no real increase in charges), and would welcome the views of stakeholders on these matters. Although the services provided by NERL are often not a large proportion of the costs of operating a flight, it is recognised its charges contribute to a cumulative impact on the viability of different routes and the choices available to passengers.

8. We will need to deal, in the best way practicable, with the severe impact of Covid-19 on the sector and the particularly uncertain path of its recovery. This will influence all the main aspects of our work on the regulatory framework for NERL, which will need to address the following two main sets of challenges:

   a) Adapting the current regulatory framework to take account of the impact of Covid-19 on the sector in 2020-2021. In doing so we will need to take account of any acute short-term issues (including possible issues relating to NERL's financeability); develop an approach to the reconciliation of traffic risk sharing (TRS) arrangements and deal with issues around the regulatory treatment of pension costs. Our approach to these matters should also allow for an appropriate transition to the regulatory arrangements that we will put in place for the next regulatory period (i.e. from 2022).

   b) Developing the future regulatory framework from 2022. We will need to develop future regulatory framework and price control arrangements in a way that is flexible to uncertainty about future costs and the speed of traffic recovery, while also supporting both the financeability of NERL and the affordability of its charges to users (in line with our statutory duties).

9. These challenges are discussed further in chapter 1.

Policy options – key themes

10. To address these challenges, we need to develop a coherent set of regulatory arrangements. The inter-relatedness of approaches and measures to address these issues in both the short and long-term, will mean it will be necessary to take a holistic view on the most appropriate way forward. Given the challenges that the sector faces, we cannot assume it will be appropriate to simply roll forward all the previous regulatory arrangements without modification. But we will look to build on the existing arrangements where appropriate so that they properly support NERL's longer-term financeability and the affordability of its charges.

11. To ensure users benefit from better and lower cost services, we want to ensure NERL has appropriate incentives for efficiency, while also protecting the quality of service. Appropriate efficiency incentives can help to maintain affordable charges for users in 2022 (when the sector is likely to be continuing to recover from the impact of Covid-19) and beyond. In addition, given the unprecedented impact of Covid-19 on the sector we will need to consider whether it is appropriate to take further steps to protect affordability, such as recovering the revenue associated with the 2020 and 2021 reconciliation over an extended period.

12. Traffic volume related risks will persist beyond 2021. We therefore need to deal with uncertainty including how best to calibrate risk-sharing for the period from 2022. Key issues include the basic calibration of risk-sharing arrangements, including understanding how costs vary with traffic levels, and the mechanisms for the reconciliation of these arrangements.

13. In considering efficiency and affordability, we need to proceed carefully so that we do not create undue risks for NERL that could lead to increases in the cost of capital, which in turn would feed into higher prices for users. It will also be important to deal with short-term issues around affordability and financeability while ensuring the longer-term interests of consumers are properly considered. For example, although in the short-term there may be scope for NERL to reasonably defer some capital spending, it is likely to be in consumers' long-term interests for NERL to invest in programmes such as airspace modernisation.

Hence, it is important the regulatory framework supports NERL's financeability and capacity to invest in the longer-term.

14. The pension costs that are passed through to regulated charges will also need to continue to be reasonable and affordable, and NERL may need the support of its pension trustees to achieve these objectives. To support the development of an appropriate approach to these matters, we are consulting on a draft regulatory policy statement (RPS) on pension costs, as set out in Appendix C.

15. In making decisions all on these matters, we will need to consider the advantages of consistency with the existing regulatory arrangements and how to protect users and have regard to NERL's financeability. However, where other more conventional measures are unable to deliver affordable user charges that support the recovery of the industry in the face of the exceptional circumstances caused by Covid-19 and the ongoing risks of very low aviation traffic volumes, we may need to consider wider measures. In those circumstances, we cannot at this stage rule out NERL's providers of equity finance needing to provide additional support, so that its charges remain affordable and its business financeable. This would require careful assessment of the overall regulatory arrangements, to protect the long-term financeability of NERL's activities and support its access to cost efficient investment grade debt finance.

16. These matters are discussed further in chapter 2, and our approach is summarised in paragraphs 2.14 to 2.16.

Process and timetable issues

17. In chapter 3, we highlight important process issues, including:

- NERL's request that we provide confirmation on our approach to TRS, to support a refinancing of its bank facilities in 2021;
- the duration of the next main price controls and our present view that, if it is practicable, we should set a five-year price control;
- the timetable for the price controls review and arrangements for NERL's next business plan; and
- how to ensure effective customer engagement.

Next steps and views invited

18. Views are invited in the matters discussed in this consultation by 12 January 2021.

19. We will consider the views of respondents and any further evidence that is provided carefully and will issue a further statement of these matters no later than February 2021.

20. Our work on NERL's next main price controls review will continue throughout 2021.

Key issues for consultation

21. Views are invited on any of the issues raised in this document and, in particular:

- the short-term challenges around the reconciliation of TRS arrangements for 2020 and 2021, pension costs and financeability;
- the longer-term challenges around maintaining the affordability of charges and financeability – and how best to deal with uncertainty, identify efficient costs, provide incentives for cost efficiency and develop arrangements that support a longer-term sustainable financial position for NERL with a cost of capital that is no higher than is necessary;
- the issues relating to the policy options for the next price controls review and our initial thinking on these matters, as summarised in chapter 2. It will be particularly important to hear from users about their priorities and how we might best assess the affordability of NERL's charges;
- the issues around the timing and duration of the next price controls, including whether we should seek to complete our substantive work on the price control review in 2021 or take longer and put interim arrangements in place for 2022;
- the timetable for the price control reviews and processes for stakeholder engagement;
- the draft regulatory policy statement in relation to pension costs, set out in Appendix C; and
- the approach to the 2020/2021 reconciliation of revenues/cost as discussed in Appendix D.

Our duties and the regulatory framework

22. In developing this consultation, we have had full regard to our statutory duties under the TA00, which are set out in Appendix B.

Regulatory framework

UK/EU transition

23. NERL has been subject to an economic regulatory framework under the TA00 and its licence since its privatisation in 2001. Since 2012, it has also been subject to the EU Single European Sky (SES) performance scheme for air navigation services (ANS). The performance scheme is established under EU regulations, which have direct effect in the UK until the end of the EU exit implementation period on 31 December 2020.

24. Currently, it is not expected that any UK/EU transition arrangements will cover economic regulation of ANS and it is expected that as of 1 January 2021, the economic regulation of NERL will revert to being solely under the framework provided by the TA00 and NERL's licence.[5] This consultation document has been developed on this basis.

ATM and UA Bill

25. Proposed amendments to some aspects of the licensing regime for the economic regulation of ATS set out in the TA00, are currently being considered under the Air Traffic Management and Unmanned Aircraft (ATM and UA) Bill, which is progressing through parliament.[6] Part 2 of the ATM and UA Bill focuses on ATS and intends to update the regulatory framework governing the provision of ATS. It will repeal and replace the current provisions covering licence modification and enforcement in Part 1 of the TA00. The proposed provisions contain a more comprehensive suite of regulatory and enforcement tools, including a new procedure for modifying licence conditions. There will also be new rights for NERL (as the licence holder), airspace users and airports whose interests are materially affected, to appeal licence modification decisions to the CMA. Additionally, the ATM and UA Bill includes provision for enforcement in respect of a breach of a condition or statutory duty.

5 Eurocontrol provides a Central Route Charges Office, which manages the collection of unit rates on behalf of its member states. Underpinning this are the Eurocontrol 'Principles for establishing the cost-base for en route charges and the calculation of unit rates'. As appropriate, our domestic framework for the regulation of NERL will take into account the UK's obligations as a member of Eurocontrol.

6 Air Traffic Management and Unmanned Aircraft Bill [HL] 2019-21

26. The process issues addressed in chapter 3 of this document, include the modification of the NERL licence to implement new price controls. This document has been developed on the basis of the current licence modification process provided for in the TA00. If the Parliamentary process for the ATM and UA Bill concludes and its requirements come into force, we will update our process and timetable as appropriate.

Structure of this document

27. The structure of this consultation document is as follows:

- chapter 1 sets out the key challenges for our review of NERL's price control arrangements;
- chapter 2 considers the policy options to address the key challenges;
- chapter 3 sets out process issues associated with the timetable for the review and provides an update on our planned review of Oceanic space-based ADS-B; and
- the appendices set out a draft RPS on pension costs, our initial thinking on the approach to the 2020 and 2021 reconciliation review, as well as providing information on our duties and a guide to the abbreviations used in this document.

Chapter 1

Challenges for the review

Introduction

1.1 This chapter sets out the key challenges as we approach our next review of NERL's price control arrangements. The severe impact of Covid-19 on the sector and the highly uncertain path of the recovery will affect all aspects of this work.

1.2 The challenges relate to the short-term (2020 and 2021) and to the next regulatory period (from 2022).

- **Responding to issues for 2020 and 2021** – the current regulatory arrangements, determined by the CMA review to apply from 2020, were established without taking account of the impact of Covid-19 on the sector. As part of the CMA's review process, we committed to carry out a reconciliation and review to take account of Covid-19. Our review will consider any acute short-term issues (including any issues that relate to short-term impacts on user charges or NERL's financeability), as well as seeking to ensure an appropriate transition to the regulatory arrangements that we will put in place for the next regulatory period.
- **Responding to issues for the new price controls from 2022** – we will also need to establish a future regulatory framework and price control arrangements that allow for both NERL's longer-term financeability and the affordability of its charges for users. This will involve:
  - dealing with uncertainty around traffic volumes;
  - identifying efficient levels of costs;
  - developing effective incentives; and
  - setting an appropriate cost of capital.

1.3 We discuss these challenges in turn below.

Responding to issues for 2020 and 2021

1.4 For 2020 and 2021, the sector is facing challenges in the near-term around:

- **Traffic risk-sharing and reconciliation** – we expect NERL will see a significant reduction in revenue in 2020 and 2021 compared with forecasts in the CMA's review for RP3. The current mechanism in NERL's licence would allow a significant proportion of the under-recovery in 2020 to be recovered in 2022, leading to a significant increase in user charges. For the 2020 and 2021 reconciliation, we will need to consider the efficient level of NERL's costs in light of lower traffic levels, and consider how traffic risk-sharing can be reasonably adapted to support recovery in the sector and affordability of user charges;
- **Financeability** – there is uncertainty regarding the recovery in traffic that could potentially create financeability challenges for NERL. Alongside this, in 2021 NERL intends to refinance arrangements it currently has in place for its bank facilities. In addition to appropriate actions being taken by NERL, we will need to consider our approach to developing the regulatory framework for NERL in a way that supports efficient and appropriate financing; and
- **Pension costs** – the next triennial valuation date for NERL's defined benefit pension scheme is 31 December 2020. How we propose to regulate NERL, including the treatment of its pension costs, will inform the NERL pension trustees' views and discussions with NERL on the future level and timing of NERL's pension contributions. Consistent with the CMA's final determination we are consulting on the development of a regulatory policy statement (RPS) on pension costs.

Traffic risk-sharing and reconciliation

1.5 The current traffic risk-sharing (TRS) mechanism provides for NERL to bear up to 4.4% of the risk around higher or lower than expected traffic levels, with revenue adjustments made with a two-year lag. In the current circumstances, the TRS arrangements would not seem to protect or further the interests of users. For example, NERL would be set to recover an additional £420 million in 2022 (based on current traffic forecasts for 2020 that are around one-third of the forecasts for 2020 in the CMA's final decision). If traffic is still below baseline levels in 2022, this could lead to user charges roughly doubling compared with the pre-Covid baseline in 2022. Even if traffic levels increased more quickly in 2021 and 2022, there would still be a significant increase in user charges at a time when the sector is recovering, and large increases may be unaffordable for airspace users in the short-term.

1.6 These TRS arrangements were put in place pursuant to the EU performance scheme. We do not expect the UK to be subject to the EU performance scheme from 2021. Nevertheless, the approach taken by the European Commission provides a relevant reference point as EU Member States face similar challenges to the UK, to balance the interests of users and air navigation service providers (ANSPs).

1.7 Further, under the EU regulation,[7] there is a provision to reconsider TRS arrangements if the variance between outturn and forecast traffic exceeds 10% – and so our reassessment of these arrangements is consistent with regulatory framework that informed the development of the TRS.

1.8 In response to the current circumstances, Member States and the Commission have agreed to amend the TRS mechanism for 2020 and 2021.[8] The amended arrangements are intended to continue to provide a level of protection from traffic risks for ANSPs for 2020 and 2021, but is set against a new target cost baseline for 2020 and 2021 that takes into account the actual and expected cost savings by ANSPs. The Commission has also said that revenue recovery against this new baseline should be spread over a five to seven-year period starting from 2023, in place of the current two-year lag.

1.9 Key elements of our work on the reconciliation for 2020 and 2021 will be to establish a reasonable and efficient level of determined costs for NERL for 2020 and 2021 and identify a level and timing of the revenue recovery that is consistent both with NERL's financeability and also the affordability of its charges. We will expect NERL to provide evidence that it has taken all reasonable steps to seek out efficiencies to support our work on these matters. Appendix D provides further detail of our initial thinking on how we will approach our assessment of costs and revenues, which will help inform policy decisions on the reconciliation.

Financeability

1.10 As NERL will need to repay its bank facilities that expire in July 2022, we expect that the company will look to access the debt markets during 2021 to support its investment programme and ongoing operations. In light of this, we will need to consider both what information might be reasonable to provide in early 2021 in support of this refinancing programme, including on the TRS arrangements, and what issues are better dealt with in the round, in setting the new price controls. We are currently considering these issues and we expect to publish further information on these matters in early 2021.

1.11 If any acute financeability issues were to arise, we will consider appropriate regulatory actions in line with our duties. But, it is important to recognise there will be limits to these regulatory levers where passing additional costs and increases in charges to users would not be affordable and would not support

7 COMMISSION IMPLEMENTING REGULATION (EU) 2019/317 of 11 February 2019 laying down a performance and charging scheme in the single European sky

8 COMMISSION IMPLEMENTING REGULATION (EU) 2020/1627 of 3 November 2020 on exceptional measures for the third reference period (2020-2024) of the single European sky performance and charging scheme due to the COVID-19 pandemic.

recovery in the sector. Therefore, it is important that NERL seeks out cost efficiencies and takes other steps necessary both to maintain its financeability and to protect the affordability of its charges. In some circumstances these steps might include seeking additional support from its providers of equity finance (as discussed further in paragraph 2.16).

RPS on pension costs

1.12 In our RP3 final decisions and as part of the CMA review for RP3, we said that we were planning to prepare a regulatory policy statement (RPS) for pension costs. The purpose of the RPS is to provide further clarity to NERL and its pension trustees on the regulatory treatment of pensions. We expected this to be in the long-term interests of customers, as during the RP3 process, NERL said it expected the RPS to provide a benefit to the valuation of pension liabilities of around £400 million from the Trustee adopting less prudent discount rates.[9] We also said we intended to finalise the RPS before the next scheduled full pension valuation that occurs every three years, which would be in December 2020.

1.13 In its review, the CMA recommended that the CAA should produce improved guidance to clarify the pass-through provisions that apply, showing circumstances when determinations of future costs would and would not be subject to pass-through. The CMA said these matters should be progressed swiftly to provide clarity on pensions.

1.14 Since the CMA's determination, we understand that the impact of Covid-19 could lead to significant upward pressures on future pension costs. It will be important that these costs remain efficient and reasonable in future so that they contribute to charges for users that continue to be affordable and would support recovery of the sector. We consider that in light of the uncertainty around Covid-19, it is important that NERL and its pension trustees continue to work together to provide this assurance. We continue to support the suggestion of an RPS on pensions in providing clarity around future arrangements and provide a draft RPS for consultation in Appendix C. NERL and its pension trustees should also consider how they can demonstrate the benefits to consumers that will flow from an RPS on NERL's pension costs. Our approach to allowing for pension costs as part of the next price control review is discussed further in chapter 2.

9 NERL's response to CAP 1758. The response can be found on our website: https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airspace/Air_Traffic_Control/NERL_RP3response_redacted.pdf

Responding to issues for the new price controls from 2022

1.15 In the broader context of developing an approach to new price controls that create a sustainable financial position for NERL and affordable charges for users, we have identified four particular challenges:

- **dealing with uncertainty around traffic volumes**. The high degree of uncertainty in traffic volumes will affect user charges, and hence affordability, NERL's costs and financeability. This makes it more difficult to develop a framework that is robust to the range of outcomes from 2022;
- **identifying efficient levels of costs**. We will need to find a robust way of assessing costs in light of the uncertainty around traffic volumes, with respect to both capital expenditure and operating costs;
- **setting effective incentives**. An important element of the framework is setting challenging targets and strong incentives to encourage NERL to deliver an appropriate level of service to customers. We will need a framework that is flexible and responds to the uncertainty around traffic volumes; and
- **maintaining an efficient cost of capital**. It is in the interest of users in the longer-term for NERL to continue to be financed on an efficient basis with a cost of capital that reflects this.

1.16 We will need to consider these challenges together to develop a coherent approach to our work on NERL's regulatory framework. This will involve retaining the key aspects of NERL's current framework and only making changes to deal with the increased level of uncertainty and the greater challenges associated with financeability and affordability. Our approach to policy is discussed further in chapter 2, with the challenges discussed in more detail below.

Uncertainty about traffic volumes

1.17 As traffic is a key building block in determining the charges to airspace users, the uncertainty in traffic volumes leads to significant uncertainty in charges to users. However, in the short to medium-term we are seeking to ensure that charges remain reasonable and affordable to support recovery of demand, in the interests of both users and NERL. Equally, any significant spikes in charges beyond 2021 and into following regulatory period would not appear to be in the interests of either users or NERL.

1.18 As we explain further in chapter 2 we will need to continue with TRS arrangements for NERL, but consider the form of these arrangements, including how and when to reconcile for the actual levels of traffic.

Identifying efficient costs

1.19 As we saw during the RP3 review, including the CMA determination, it can be challenging to establish efficient levels for operating and capital costs, even without the uncertainty created by the impact of Covid-19. The additional uncertainty in traffic forecasts creates further challenges:

i. NERL will need to plan its operations around an uncertain traffic forecast. We would expect NERL to provide a flexible response that seeks to vary its operations and costs in line with changes in traffic forecasts as far as is practicable and efficient;

ii. NERL will need to consider what investment programmes are appropriate in different scenarios for traffic, as it may be that some discretionary programmes should be delayed until the recovery is stronger – taking due account of the benefits of investment and the importance of supporting airspace modernisation; and

iii. NERL has significant pension cost obligations from its defined benefit scheme. We understand that the pension deficit costs may be under further pressure as a result of the impact of Covid-19 and, as set out during RP3, we would expect NERL to work with its pension trustees to ensure these costs remain reasonable.

Setting effective incentives

1.20 During the next regulatory period, it will be important to set appropriate incentives around cost efficiency, which respond to the large degree of uncertainty. This will involve considering how efficiency gains should be shared between NERL and users. Any approach to robust cost incentives will also need to minimise the potential for unintended consequences. The continuation of the capital expenditure incentives and governance arrangements implemented as part of the RP3 determination will have a key role in ensuring that NERL adopts a flexible and efficient approach to investment. We will also want to ensure that those incentives and governance arrangements allow NERL to take due account of the impact of its investments not only on service quality and efficient capital expenditure, but also in relation to delivering more efficiency in terms of operating costs.

1.21 The existing regulatory framework and price controls include service quality incentives in relation to delay and flight efficiency performance. Traffic is a significant driver for how easy or challenging it is for NERL to deliver on service quality. Greater uncertainty around traffic levels makes it more difficult to calibrate sufficiently challenging delay and flight efficiency targets and to determine the appropriate strength of incentives. We will want to ensure that targets and incentives drive NERL behaviour and do not result in NERL being unduly rewarded or penalised or those incentives blunted as a result of traffic being significantly different from the levels used to set targets.

Maintaining an efficient cost of capital

1.22 To maintain efficient costs for users over the medium and longer-term, we understand the need to ensure that the future required cost of capital is no higher than is necessary. This will be an important factor in our consideration of the appropriate traffic risk-sharing and cost risk-sharing mechanisms from 2022. The impact of Covid-19 is likely to have shifted the perceived and actual risks in the sector, so we will need to consider how to take account of this and the package of price control measures that mitigate risks, such as traffic and pension cost risk-sharing.

Key issues for consultation

1.23 Views are invited on any aspects of the main challenges associated with establishing new price control arrangements for NERL and whether we have identified the main issues, including:

- the short-term challenges around the reconciliation of TRS arrangements in 2020 and 2021, pension costs and financeability; and
- longer-term challenges around maintaining the affordability of charges and financeability – and how best to deal with uncertainty, identify efficient costs, provide incentives for cost efficiency and develop arrangements that support a longer-term sustainable financial position for NERL with a cost of capital that is no higher than is necessary.

Chapter 2
Policy options

Introduction

2.1 In chapter 1, we identified a number of key challenges for our work on the reconciliation for 2020 and 2021 and wider price control review. This chapter seeks to start to identify and develop broad packages of policy options and measures that will help meet these challenges.

2.2 We will need to ensure any policy measures are consistent with our duties under the TA00, including to protect the interests of users and secure that NERL will not find it unduly difficult to finance its activities, and address both the short and medium-term challenges discussed in chapter 1. By selecting the most appropriate package of measures we should be able to develop a set of regulatory arrangements for NERL that deal with short-term issues it faces and provide the basis for a sustainable future, with NERL being able to finance investment while maintaining charges for users at an affordable level.

2.3 A natural starting point for our assessment is the current regulatory framework for NERL. We identify the main features of this framework below and then go on to consider how it can be adapted to meet the challenges that have been created by the impact of Covid-19.

2.4 As noted in chapter 1, NERL is seeking early confirmation on the future regulatory framework to support a refinancing of its bank facilities. We will adopt a balanced approach consistent with our statutory duties and will seek to both provide NERL with reasonable comfort and also provide assurance to users that NERL's charges will be affordable and will support the recovery of the aviation sector in 2021, 2022 and beyond. NERL will need to actively support these broader aims, which may require support from wider stakeholders, including NERL's shareholders and pension trustees.

Rolling forward the current regulatory framework

2.5 The current regulatory framework has evolved over several price control periods to reflect both the EU performance scheme and our statutory duties under the TA00. While we do not expect key elements of the EU framework to apply to the UK from 2021, the underlying regulatory framework for NERL has been developed in a way consistent with our TA00 obligations. We expect the main elements of this framework to remain in place including the regulatory asset base (RAB) based approach to setting price controls. Nonetheless, we will consider changes where these are necessary to help deal with the difficult circumstances created by Covid-19 or to assist the recovery of the sector and protect the affordability of charges during this period. Future price control arrangements based on this broad approach would have the following key features:

- completing the TRS reconciliation for 2020 and 2021 in a way that is broadly consistent with the approach recently adopted by the EU. This recognises that ANSPs had a specified TRS mechanism in place for 2020 and 2021, but reflects the need for the mechanism to be adapted to take into account the cost savings that have been made and smoothing the impact of the future revenue recovery on charges by making the adjustments over a number of years;
- a five-year RAB-based price control for NERL with the smoothing of charges achieved by the profiling of prices over the period and, if necessary, allowing NERL's RAB to increase to facilitate the recovery of costs in later periods;
- TRS arrangements from 2022 similar to the RP3 approach with the intention of providing NERL with substantial protection from traffic risk; and
- maintaining a substantial element of cost pass-through for efficient and reasonable pension costs, in line with the current arrangements that allow NERL to pass through costs over which it has limited control, such as the impact of financial markets on pension costs and for changing government legislation.

2.6 Maintaining an approach based around the existing regulatory framework has the advantage of regulatory consistency and stability and would provide NERL with a very high degree of protection from uncertainty and unexpected cost increases. While this is likely to protect NERL from risks and be consistent with a relatively low cost of capital, we also need to consider whether modifications to this approach will be necessary to ensure NERL's charges remain affordable and better protect users, during the recovery.

2.7 Options for making improvements to the present regulatory framework are discussed further below.

Improving incentives for efficiency

2.8 There are a number of options for improving incentives for efficiency, including:

a) making strong efficiency assumptions with respect to estimating the operating cost and capital expenditure allowances that will be used to help calibrate NERL's price controls for the period from 2022;

b) ensuring that the assumptions on costs that will be used in the TRS reconciliation reflect assumptions on efficient costs rather than simply reflecting actual costs incurred by NERL;

c) calibrating the forward-looking TRS arrangements in a way that ensures changes to NERL's future revenues that occur because of changes in traffic reflect the way NERL's cost change. For example, if traffic changes, future revenues under the TRS are no more than the additional incremental costs that NERL would likely incur, or costs it would avoid, if it is operating efficiently. This would necessarily take due account of specific constraints in terms of training and capital investment lead times; and

d) setting greater incentives for capex efficiency and ensuring NERL retains incentives for efficiency across both capital expenditure and operating costs.

2.9 The advantages of sharpening the incentives for efficiency is that over time this could lead to lower overall costs and prices for users. Nonetheless, care needs to be taken with these arrangements as they may create greater risks for NERL (as in practice it may not be able to achieve the cost targets that would be part of these arrangements) and so could put upward pressure on the cost of capital. We also need to be mindful of the obligations on NERL to provide a high quality and resilient services – and so NERL need to focus on cost efficiency rather than cost reduction. NERL has licence obligations with respect to quality of service that are independent of its price control obligations and it should only accept new price obligations if these are consistent with its delivery of these obligations, as it would be for NERL to bear the risks and costs of any non-compliance.

2.10 While better incentives for efficiency should support affordability, given the scale of the challenges that NERL and the wider sector faces, it will also be appropriate to consider other measures.

Other measures to support affordability

2.11 As well as supporting the financeability of NERL in the longer-term it will be important that the regulatory arrangements for NERL support the recovery of the sector. This means maintaining an affordable level of charges, particularly in 2021 and 2022, but also in subsequent years. Affordable charges will make more routes viable, which should support the recovery of air traffic, thereby bringing in more revenue to cover NERL's costs and providing more choice and services for passengers.

2.12 Given the difficult circumstances faced by the sector we may need to build on the improvements for efficiency discussed above, with measures directly targeting affordability. The best options for dealing with affordability are likely to include extending the period over which NERL recovers the reconciliation of revenue from 2020 and 2021 – one mechanism could be adding to the RAB and delaying the start of the recovery of regulatory depreciation and/or increasing the number of years over which regulatory depreciation is recovered. These measures would support affordability and should not put undue strain on financeability.

2.13 Nonetheless, there could be plausible scenarios where the combination of improved incentives for efficiency and the better profiling of revenue does not result in affordable charges, to support recovery in the short-term. We will consider further work on these matters and the recent news with respect to vaccine development may make these scenarios significantly less likely than would otherwise have been the case.

2.14 The exceptional circumstance of Covid-19 and the possibility of scenarios with significant pressure on affordability mean that we cannot rule out additional modifications to the regulatory framework to support affordability. Although the starting point for our work on the reconciliation of TRS arrangements is very much the fine tuning of the existing mechanism, these arrangements include a carve out for exceptional circumstances. In deciding whether to make any changes to the TRS mechanism to reflect this carve out we will be guided by our statutory duties. Our initial view is that if it were essential to support affordable charges, we would consider additional measures in the exceptional circumstances of Covid-19. These could include a solution where NERL does not recover all the shortfall in revenue from 2020 and 2021 that will derive from the mechanistic application of the TRS from users, perhaps with shareholders bearing a proportion of the shortfall. Such an approach would require careful assessment taking into account the overall package of price control measures and it would also be important to protect the long-term financeability of NERL's activities and support its future access to cost efficient investment grade finance (otherwise NERL's cost of capital may increase that would then place additional pressure on affordability).

2.15 The same exceptional circumstances mean similar considerations could apply to the regulatory treatment of NERL's pension costs. At present the regulatory framework provides a high degree of protection for the recovery of NERL's defined benefit pension scheme costs. It will be important that NERL works hard with its pension trustees to keep pension costs both reasonable and affordable. If there were to be further significant upward pressures on NERL's pension costs, NERL and its pension trustees will need to take steps to try and moderate these costs. Otherwise, there may be circumstances such that to protect the interests for users, we would need to consider whether it is appropriate in setting price control arrangements to assume shareholders bear a proportion of any significant cost increases. As above in the case of changes to TRS arrangements, such an approach would require careful consideration and implementation, so that it did not unduly undermine NERL's wider financeability. Further, in order to support the recovery of reasonable and efficient pension costs we are consulting on a draft RPS for pensions, as set out in Appendix C of this document.

Additional equity support

2.16 Given the present crisis facing the aviation sector, and the circumstances we refer to above in paragraphs 2.14 and 2.15, we cannot at this stage rule out NERL requiring further support from the providers of equity finance – to help manage financeability and/or affordability issues in the short-term. This could either be in the form of foregone dividends, new equity injections, shareholder loans or guarantees. Nonetheless, we will seek where practicable to use established regulatory practice (such as setting more stretching efficiency targets and smoothing the recovery of revenues over time) to manage issues of affordability of charges and financeability, and only assume further support from equity finance if it is needed to reasonably support the discharge of our statutory duties.

Dealing with future uncertainty

2.17 As well as the challenges around incentives for efficiency and affordability of charges, it will be important that the regulatory arrangements for NERL deal adequately with uncertainty. We anticipate a relatively high degree of uncertainty is likely to persist into 2021 and perhaps 2022. Hence, we need to consider how best to calibrate TRS for the period 2022 and beyond, including how any variances arising from the application of the TRS should be recovered, or returned to users.

2.18 As discussed above, we set out that the recovery of revenues associated with TRS in 2020 and 2021 could be profiled over a longer time period. Similarly, for TRS arrangements for 2022 and beyond, an adjustment could be made to NERL’s RAB (and so recover revenues more slowly over time) rather than an adjustment to revenue (as was the case during the RP2).

2.19 In dealing with uncertainty, we will also need to consider the best approach to making allowances for NERL’s operating and capital costs. Greater uncertainty over traffic and hence efficient levels of costs could alter the proportion of expenditure we identify in our base allowance under the charge control, while allowing for higher levels of expenditure where traffic recovers more quickly than forecast.

Providing sufficient funding to support airspace modernisation

2.20 In the medium term, it will also be important that NERL supports the programme for airspace modernisation as this will bring longer-term benefits in terms of greater flight efficiency, shorter journey times and reductions in harmful environmental emissions. This underlines the importance of establishing a regulatory framework for NERL that supports its longer-term financeability.

Key issues for consultation

2.21 There are strong inter-relationships between many of the above issues and it will be key to establish a coherent overall approach across the full range of issues. Views are invited on any issues relating to the policy options for the next price controls review and our initial thinking on these matters as summarised in this chapter. It will be particularly important to hear from users about their priorities and how we might best assess the affordability of NERL’s charges in the short and medium-term.

Chapter 3

Process issues

Introduction

3.1 This chapter considers some of the process and timetable issues for this price controls review. Some of these issues will be informed by the policy approaches discussed in earlier chapters. We also need to take account of the significant pressure on the resource levels of sector participants and so maximise the agility and effectiveness of the stakeholder engagement processes. The main areas for consideration are the:

- NERL's request for confirmation of our approach to TRS, to support a refinancing of its bank facilities in 2021;
- timing and duration of the next price controls;
- the timetable for the price controls review;
- the development of NERL's business plan; and
- approach to effective stakeholder engagement.

3.2 In addition, we set out our approach to further work on the review of the Oceanic spaced-based ADS-B.

Confirmation of our approach to TRS

3.3 NERL is planning to undertake an exercise to refinance its bank facilities in early 2021 and has sought regulatory clarity to our approach to economic regulation of NERL, and TRS in particular, to support this activity. Greater certainty over the TRS arrangements would enable providers of finance to better understand the risks attached to their investments. Where NERL is able to rely on a stable regulatory framework, investors and banks will tend to attach less risk to finance, and NERL should be able to access finance more efficiently, which will lead to lower charges for users.

3.4 Our final TRS policy will necessarily be set out as part of our wider price controls proposals, later in the review. However, we consider that there are benefits to NERL and users, consistent with our statutory duties, if we are able to set out the principles that will underpin our approach to TRS early next year, to support NERL's refinancing of its bank facilities.

Timing and duration of the next price controls

3.5 We need to consider the date from which the next price controls should commence and their duration.

3.6 The existing price controls run from January 2020 to December 2022. While this creates a backstop, in its final report the CMA said that as it had not been able to take account of the impact of Covid-19 on the sector it would not be in the public interest for the price controls set out in its final report to apply for longer than strictly necessary. The decision to apply the controls until December 2022 was to provide sufficient time for us to complete our review of new price control arrangements. Nonetheless, the CMA considered we should aim to complete that review as soon as feasible, when the situation of the aviation sector reaches an adequate level of stability.[10]

3.7 The automatic application of the TRS under the existing controls means that NERL would be eligible to recover all of its under-recovered 2020 revenue, in 2022. This would lead to a significant and unaffordable spike in user charges. As a minimum, it will therefore be necessary to make modifications to NERL's licence to implement updated TRS arrangements before January 2022, even if it is considered appropriate to allow the other aspects of the existing controls to run until the end of 2022.

3.8 It is also appropriate to consider whether there would be benefits to completing the full review in 2021 and implementing wider aspects of the new price controls before the existing controls expire – i.e. at the start of 2022 – or taking longer and implementing new arrangements from the start of 2023.

3.9 Completing the review in 2021 and implementing full new price controls in January 2022 would provide an opportunity to update traffic and cost forecasts to reflect the reality of the impact of Covid-19. While it would require a focussed effort by all parties to complete the review, it could establish new five-year controls that better reflect the priorities as the sector recovers from the impact of Covid-19 and, more appropriate costs for the period. Implementing new controls in 2022 would likely need to consider additional cost incentives/risk-sharing mechanisms given uncertainty about future costs and requirements, as discussed in chapter 2.

3.10 Allowing the remainder of the existing controls to run their course would provide more time for the review process to complete and enable both us and stakeholders to consider the full breadth of issues, more akin to a 'conventional' review. It would also provide more time to assess how traffic is recovering and

10 CMA Final Determination, page 52, paragraph 5.28: https://assets.publishing.service.gov.uk/media/5f350e17e90e0732e0f31c2a/NATS_-_CAA_final_report_for_publication_August_2020_-----.pdf

reduce uncertainty in terms of new traffic forecasts. Nonetheless, we would need to establish interim price control arrangements for 2022.

Control duration

3.11 In addition to considering when the next price controls should take effect, it is necessary to consider how long the next regulatory period should last. A shorter, interim, control (of one or two years) may address some of the issues around short-term uncertainty in respect of traffic and costs. On the other hand, it may introduce longer-term regulatory uncertainty, with the potential to adversely affect the efficient cost of capital. A short control would inevitably mean work on the next review would need to start very soon after the new controls were implemented, which would have resource implications.

3.12 Our initial view is that a longer duration controls would have strong benefits in terms of regulatory stability and incentives. However, given the current exceptional circumstances and timetable (discussed further below) we would welcome views on the timing and duration of new controls and the merits of interim arrangements.

Price control review process

3.13 Key drivers for the timetable for this review will be the issues set out in chapter 1, the approach to policy options as discussed chapter 2 and the timing and duration of the controls discussed above. Although the timetable cannot be finalised until the policy approach is determined, there are a number of key stages that we followed in previous reviews that it is useful to consider in terms of processes and timings.

3.14 The RP3 review took over two years from the publication of a strategic outcomes discussion document, to the publication of the CAA Board decision.

April 2017	Strategic outcomes discussion document
September 2017	Consultation on business plan guidance to NERL
January 2018	CAA business plan guidance to NERL
April 2018	NERL initial business plan (IBP)
May 2018 to September 2018	NERL customer consultation process
September 2018	Customer Consultation Working Group report
October 2018	NERL revised business plan (RBP)

February 2019	CAA draft price control proposals
July 2019	CAA Board decision on final RP3 determination
August 2019	Publication of the CAA RP3 decision document.

3.15 During 2018 and early 2019, CAA's expert advisers also reviewed NERL's submissions and provided advice on other aspects of the price controls.

3.16 Some of the RP3 milestones were driven by the need for consistency with the EU performance scheme requirements, which currently are not expected to apply to the UK from January 2021. Nevertheless, it takes approximately three months, following the CAA final determination, to complete the statutory process to modify the NERL licence and implement new price controls (where NERL consents to the licence modifications).

Implementation date

3.17 Taking account of the three months required to implement a final determination, a CAA decision would be required in October 2021 in order to make the licence modifications to give effect to new price controls from January 2022. This would then mean that all NERL customer consultation and CAA stakeholder consultation on draft proposals would have to be completed by late summer 2021. While alternative approaches to both NERL customer and CAA stakeholder consultation activities could be considered to reduce the timetable (this is discussed below), developing policy responses to the issues raised in chapter 1 and making a robust CAA final determination by autumn 2021 would still present a significant challenge.

3.18 It would be possible to create more time for the review processes, by delaying the licence modification/price controls implementation date until 2022, for example the end of the first quarter of 2022. Such a relatively short delay would provide greater flexibility and should have limited adverse impact in terms of delivery of NERL programmes under its new controls. It would also allow more time for actual traffic evolution to be factored into forecasts, thus to some extent providing some mitigation in respect of risks associated with traffic evolution.

3.19 Alternatively, we could look to establish interim arrangements for 2022 and implement the full review from the start of 2023 as discussed above.

NERL business plan development

3.20 NERL will need to develop a business plan for the new regulatory period. In RP2 and RP3, NERL followed a broadly similar approach whereby it issued an initial business plan (IBP) and then, following customer consultation, a revised business plan (RBP). For RP3, NERL shared its IBP in spring 2018 and then submitted its RBP to the CAA in October 2018. In the intervening period, NERL conducted a structured customer consultation process including a series of meetings and workshops to discuss specific aspects of the IBP. Transposing that approach to 2021 could require both a truncated NERL customer consultation timetable, as well as other steps, such as reducing the consultation on CAA's draft proposals and potentially delaying the implementation date.

3.21 A more flexible and agile approach to the development of NERL's business plan and its approach to customer consultation could deliver benefits for all parties. It could enable more efficient use of time and resources and support more effective discussions and understanding relative positions. This could include:

- **Flexible engagement on specific topics rather than a single consolidated IBP**: instead of NERL waiting until it has produced a complete IBP for all aspects of business, it could produce a series of working papers/analyses on key elements and programmes as the basis for discussion with customers, ahead of a production of a single business plan for submission to the CAA. Such an approach would require early dialogue and agreement between interested parties on required outputs and agreement of the programme of work; or
- **Prioritising the areas for the IBP**: as a variant of the above, NERL could prioritise the development of specific parts of the business plan that are most important to its customers and the customer consultation process.

Stakeholder roles and customer consultation

3.22 For both RP2 and RP3 a 'Customer Consultation Working Group' (CCWG) was established and led by co-chairs from NERL and the user community. As well as managing the CCWG meetings and workshops process, the role of the CCWG co-chairs was to produce a report setting out areas of agreement and disagreement between NERL and its customers.

3.23 Subject to the approach to business plan development, discussed above, and stakeholder views on the efficacy of the RP2 and RP3 CCWG processes, further consideration will be required to determine what improvements to this approach could be made. We recognise that both users and NERL have taken significant steps to constrain costs in response to the impact of Covid-19, which might impact the ability of stakeholders to effectively engage in price control review processes.

3.24 Additionally, historically the CAA has maintained an observer role during the CCWG process. During development of our draft proposals we have then sought additional information and detail from NERL to inform our policy.

3.25 There may be benefits to reconsidering this approach, with perhaps the CAA playing a more proactive role during the 'CCWG' process. This could help reveal more pertinent information for both CAA and users earlier in the process and provide an opportunity to better signal initial views and reactions to NERL outputs. Any such more interactive role for the CAA, would need to ensure it did not diminish the opportunity for users to continue to effectively engage directly with NERL.

CAA draft proposals

3.26 Historically, our draft proposals for formal consultation have been developed once the NERL customer consultation process is complete, the CCWG has published its co-chairs report, NERL has submitted its RBP and our expert advisers' reports have been made available.

3.27 Similar to consideration of alternative approaches to the development of the NERL business plan, we could seek to take a more agile approach to the development of our proposals, with the publication of working papers setting out our initial views, and the initial views of our external advisers, alongside the NERL engagement process. Such an approach could complement a more proactive role for CAA in the NERL customer engagement process, however, it would need to ensure it did not diminish the opportunity for users to engage effectively, maintain clear distinctions between parties' respective roles and not fetter our decision-making discretion later in the process. It should be recognised that such an approach would also likely increase the burden on NERL, users and the CAA in the development of, and proper engagement on, outputs – especially at a time when the industry is already severely stretched.

Conclusions and key issues for consultation

3.28 We will need to modify the NERL licence before January 2022 to ensure the otherwise automatic application of the TRS mechanism does not result in a significant spike in charges in 2022.

3.29 The policy approach to the next review will be a key driver for the timetable and processes we follow. However, regardless of the policy approach, it is clear that it would be very challenging to follow the same or similar approach to previously used in the RP2 and RP3 reviews. We have identified some approaches that might streamline the process, but these could also introduce additional burdens on stakeholders.

3.30 We welcome stakeholders' views on these issues around the timing and duration of the next price controls. In particular, we are keen to understand stakeholders' preferences in terms of completing the review in 2021, with the potential for shorter control arrangements; or completing the review in 2022, with transitional arrangements for 2022. We also welcome views on the likely bandwidth of stakeholders to effectively participate in the review processes and any ideas on how to address any constraints.

Review of space-based ADS-B

Context

3.31 As part of our RP3 decision we allowed NERL to recover costs associated with the introduction on space-based Automatic Dependent Surveillance-Broadcast (ADS-B) for its Oceanic activities. In its review of the RP3 price controls, the CMA agreed that it was appropriate for NERL to include an uplift to its Oceanic charges to recover the costs of space-based ADS-B, noting that ADS-B is needed to meet ICAO safety requirements. The CMA removed the 5% efficiency adjustment that we applied in our decision.

3.32 The CMA's view was that the CAA could reconsider the regulatory allowance for ADS-B and any efficiency adjustments following an independent review on the costs and benefits of the service. It required the CAA to establish a satisfactory review methodology, including being clearer and more transparent about the timing, methodology, conduct and consequences of the proposed independent review before it commenced. The CMA encouraged us to consider our approach to this review and consult on this by the end of 2020.

Update

3.33 Covid-19 has had a significant impact on all ATM stakeholders including the CAA and we have not progressed our work in this area. We consider that there are three high-level questions we should address before developing our approach to the independent review:

- what metrics should be used to assess the cost and benefits of ADS-B;
- what circumstances and air traffic volumes would we need to see before a meaningful review can take place; and
- who should conduct the review?

3.34 We held a workshop in February 2020 to consider questions relevant to the assessment of the costs and benefits of ADS-B. We are also aware that ICAO has been conducting a trial that includes both an assessment of the technical performance of ADS-B and its impacts on airlines' operational efficiency.

3.35 However, the current reduction in transatlantic traffic resulting from the Covid-19 pandemic, coupled with its effect on stakeholders means that we do not currently have sufficient information to be able to determine what approach is suitable or to consult on the key issues. To make progress in this area, we propose to engage informally with stakeholders in the coming months to follow up on the issues raised at the workshop earlier this year. We will also seek more information on what data may be available from the ICAO trial. We intend to publish a formal consultation in the light of this work.

APPENDIX A

Abbreviations

Abbreviations	
ACOG	Airspace Change Organising Group
ADS-B	Automatic Dependent Surveillance-Broadcast
ANS	Air navigation services
ANSPs	Air Navigation Service Providers
ATM	Air traffic management
ATM & UA Bill	Air Traffic Management and Unmanned Aircraft Bill
ATS	Air traffic services
CAA	Civil Aviation Authority
CAAPS	Civil Aviation Authority Pension Scheme
capex	capital expenditure
CCWG	Customer Consultation Working Group
CMA	Competition and Markets Authority
Commission	European Commission
DB	defined benefit
DC	defined contributions
DC	Determined cost
DIWE	Demonstrably inefficient and/or wasteful expenditure
DUC	Determined unit cost
EU	European Union
IBP	Initial Business Plan
ICAO	International Civil Aviation Organisation
IPCR	Independent Planning Cost Reviewer
NATS	National Air Traffic Services
NERL	NATS (En Route) plc
opex	operating costs
RAB	Regulatory Asset Base
RBP	Revised Business Plan
RPS	Regulatory Policy Statement
RP2	Reference Period 2 (2015-2019)
RP3	Reference Period 3 (2020-2024)

Abbreviations	
SES	Single European Sky
TA00	Transport Act 2000
totex	total expenditure
tPR	the Pensions Regulator
TRS	Traffic Risk Sharing
WACC	Weighted average cost of capital

APPENDIX B

CAA duties

Our duties in respect of air traffic services are set out in section 2 of the Transport Act 2000, which is reproduced below.

2. CAA's general duty.

(1) The CAA must exercise its functions under this Chapter so as to maintain a high standard of safety in the provision of air traffic services; and that duty is to have priority over the application of subsections (2) to (5).

(2) The CAA must exercise its functions under this Chapter in the manner it thinks best calculated—

(a) to further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them;

(b) to promote efficiency and economy on the part of licence holders;

(c) to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences;

(d) to take account of any international obligations of the United Kingdom notified to the CAA by the Secretary of State (whatever the time or purpose of the notification);

(e) to take account of any guidance on environmental objectives given to the CAA by the Secretary of State after the coming into force of this section.

(3) The only interests to be considered under subsection (2)(a) are interests regarding the range, availability, continuity, cost and quality of air traffic services.

(4) The reference in subsection (2)(a) to furthering interests includes a reference to furthering them (where the CAA thinks it appropriate) by promoting competition in the provision of air traffic services.

(5) If in a particular case there is a conflict in the application of the provisions of subsections (2) to (4), in relation to that case the CAA must apply them in the manner it thinks is reasonable having regard to them as a whole.

(6) The CAA must exercise its functions under this Chapter so as to impose on licence holders the minimum restrictions which are consistent with the exercise of those functions.

(7) Section 4 of the Civil Aviation Act 1982 (CAA's general objectives) does not apply in relation to the performance by the CAA of its functions under this Chapter.

APPENDIX C

DRAFT regulatory policy statement – Policy principles relating to NERL defined benefit pension scheme costs

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 (the Licence). On 29 August 2019, we published our decision (RP3 Decision) setting out proposed modifications to NERL's licence for the economic regulation of NERL during the period 2020 to 2024 (RP3). Our RP3 Decision included a statement of our support in principle to NERL's request, set out in its RP3 Business Plan,[11] for a regulatory policy statement (RPS) pertaining to pension costs.[12]

2. NERL rejected the proposed Licence modifications in our RP3 Decision and on 19 November 2019 we made a reference to the Competition and Markets Authority (CMA) to investigate and report on the proposed modifications.

3. In its provisional findings, the CMA supported the intended development of an RPS and considered that this would be an opportunity for us to provide further clarification on the pension pass-through mechanism.

4. On 23 July 2020, the CMA made its final report on the reference. The CMA recommended that we should provide improved guidance to clarify the pass-through provisions that apply, showing circumstances when determinations of future costs would and would not be subject to pass through.[13]

Background

5. The CAA Pension Scheme (CAAPS) was split into two separately governed sections on NATS separation from the CAA: one for CAA members; and one for NATS Group members (the NATS Section). The NATS Section is a Defined Benefit pensions scheme (DB Pension Scheme), which was closed to new NATS employees from 2009, but allows existing members to continue to accrue

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11 CAA RP3 Decision, Appendix O

12 CAA RP3 Decision, paragraph 5.78

13 CMA Final Report, paragraph 11.35

benefits. A Defined Contribution (DC) pension scheme was introduced for new NATS employees from 2009.

6. Pension costs are a key component of NERL's cost base, and allowances for reasonable and efficient pension costs are included in NERL's determined costs for each regulatory period.

7. Generally, NERL has borne the risk – and opportunity – where there are differences between the allowances for operating costs assumed in setting its price controls and the actual costs it incurs, thereby creating a strong incentive on NERL to outperform its price control determination. However, in respect of DB pension costs, there is an exception where any difference between determined and actual costs are recovered from – or repaid to – users. This is because the underlying causes of these differences are generally accepted to be beyond NERL's reasonable control (unforeseen and significant changes in DB pension costs resulting from unforeseeable changes in national pensions law, pensions accounting law or unforeseeable changes in financial market conditions and where the changes in DB pension costs are outside the control of NERL). In the case of cost increases, NERL also has to demonstrate it has taken reasonable measures to manage cost increases during the control period.[14]

8. Without this provision, it would be necessary to take account of the additional risk NERL would bear in setting its cost of capital, which could lead to higher charges for users. Making this exception in relation to DB pension costs therefore furthers users' interests, promotes efficiency and economy on the part of NERL and also supports its financeability. This exception does not apply to NERL's DC pension costs as these are considered to be wholly within the control of NERL.

9. The circumstances created by Covid-19 are relevant to the RPS on pension costs insofar as there is the scope for significantly greater pressure on the affordability of NERL's charges to users. In these exceptional and difficult circumstances, all stakeholders should be prepared to play a part in helping deal with these difficulties. We expect both NERL and its pension trustees to take the necessary steps to ensure that the level of NERL's pension costs remain affordable.

10. Bearing the above in mind, the purpose of this RPS is to provide guidance to NERL and the Trustee of the NATS Section of the CAAPS, on the principles to be applied in determining the level of DB Pension Scheme pension costs (the

[14] As appropriate, our domestic framework for the regulation of NERL will take into account the UK's obligations as a member of Eurocontrol. Our approach to pension pass-through provisions is consistent with the Eurocontrol 'Principles for establishing the cost-base for en route charges and the calculation of unit rates', Paragraph 3.3.4.2(c).

Pension Costs) that we will use to inform our decisions on NERL's price controls and the arrangements and in relation to the recovery of any significant and unforeseen changes to the Pension Costs by way of the pass-through mechanism discussed above.

11. In considering the application of this RPS, it is important that NERL and its pension trustee are able to demonstrate how their actions align with, and drive, consumer benefit both now and in the future.

Regulatory Policy Statement

This RPS sets out the principles which we expect NERL and/or the Trustee of the NATS Section of the Civil Aviation Authority Pension Scheme (the NATS Section) and/or the CAA to apply in relation to the Pension Costs.

Section 1: Principles to be applied by NERL and/or the Trustee of the NATS Section (the Trustee)

Principle 1: efficient Pension Costs

1. Airspace users should only pay for Pension Costs that are reasonable, efficiently incurred and reflective of actual market conditions. Airspace users should not pay for Pension Costs that are excessive or avoidable by efficient management and/or reasonable Trustee action.

2. We acknowledge the Trustee is not subject to economic regulation by the CAA and is governed by separate pensions legislation and regulated by the Pensions Regulator (tPR). Notwithstanding this, we expect to see evidence of good stewardship of the DB Pension Scheme to ensure that airspace users do not bear costs from a material failure in stewardship. The CAA expects the Trustee to operate the DB Pension Scheme in accordance with all relevant legislation, regulations, guidance from tPR and industry best practice standards of governance.

3. We expect NERL to behave in a manner consistent with a commercially minded company by taking all steps available to it which are within its legal discretion and which are in the interests of airspace users. We expect NERL to work with the Trustee and both parties to take appropriate actions to mitigate and to manage properly the Pension Cost burden on airspace users, both now and in the future.

4. We expect NERL and the Trustee to provide evidence to demonstrate that they have done all they reasonably can to mitigate the burden on airspace users arising from its pension obligations and that they have taken steps to ensure that the level of NERL's pension costs remain affordable.

Principle 2: appropriate actuarial valuations

5. Pension Costs should be assessed by the Trustee using actuarial methods, on the basis of reasonable and prudent assumptions in line with national law and current best practice, taking into account the strength of the employer's covenant, the interests of airspace users and reflecting our commitment to fund reasonable and efficiently incurred Pension Costs.

6. We expect the level of the DB Pension Scheme funding to be assessed on the basis of forward-looking prudent assumptions regarding long-run investment returns and other key variables by appropriately appointed actuaries.

7. In the case of a pension deficit being confirmed at any formal full actuarial review, such deficit should be funded over a reasonable period thereafter, taking into account the strength of the employer's covenant, the interests of airspace users, our commitment to fund reasonable and efficiently incurred Pension Costs and prevailing guidance from tPR.

8. We expect NERL to provide evidence of benchmarking of the Trustee valuation assumptions against those adopted by trustees operating schemes in sectors of the economy open to normal commercial and competitive pressures.

Principle 3: good stewardship

9. We expect NERL to play an active role in ensuring the good and effective governance of the DB Pension Scheme.

10. When establishing the allowances for Pension Costs we may seek independent actuarial advice on NERL's projections for the relevant control period. We will also have regard to the assumptions supporting NERL's projections, including the outcome of any recent Trustee valuations of the DB Pension Scheme, and the stewardship of the DB Pension Scheme.

Principle 4: long-term funding and investment strategy

11. In considering the long-term funding objective of the DB Pension Scheme, and the investment strategy required to deliver this, we expect the Trustees to take into account the strength of the employer's covenant including the reliance that can be placed on the stability of the framework for economic regulation.

12. Although DB pension liabilities represent a fixed obligation, the DB Pension Scheme valuation is subject to change caused by exogenous factors, including for example changes in the value of stock markets, real interest rates, or changes in longevity assumptions. Some of these factors can be managed through the investment strategy adopted by the Trustee. There is a balance to be struck between taking higher levels of investment risk with the aim that the additional returns expected will result in lower ultimate Pension Costs and taking too much investment risk which could lead to a more volatile funding position and potentially higher deficit contributions.

13. As the DB Pension Scheme is closed to new members, there is an expectation that the DB Pension Scheme will mature relatively quickly, as active members retire or leave the DB Pension Scheme (either through leaving employment or taking the pension cash alternative). As the DB Pension Scheme matures further, it is our understanding that the Trustee will want to invest in assets to generate income and cash flows which are expected to match the benefit payments to pensioners.

14. There are various investment strategies which could achieve this and we expect that the cost implications for NERL's contributions are appropriately taken into account when deciding on the strategy.

Principle 5: de-risking and treatment of surpluses

15. As referred to above, as the DB Pension Scheme matures we expect that an increasingly risk reducing investment strategy will be developed. This could involve rebalancing from riskier to less risky assets, employing and/or increasing hedging, buy-ins, buyouts and other risk-reducing approaches. In considering these options and the pace of de-risking, we would expect the Trustee and NERL to take account of the relevant costs and consumer benefits both now and in the future, taking advice from experts as appropriate.

16. Given the regulatory assurance that this RPS is intended to provide (i.e. that DB Pension Scheme costs will be remunerated subject to the conditions this RPS contains), we would expect consideration to be given to applying any emerging surplus both to de-risking and to lowering NERL's pension contributions to reduce the burden on airspace users who are funding the DB Pension Scheme when it is in deficit.

17. In the event of a surplus being recognised at a future actuarial valuation:

    i. in relation to deficit repair contributions, we expect these to no longer be required and, as a result, we expect airspace users to benefit from such a situation through lower charges set at the next price control or during the price control period through the pension cost pass through mechanism; and

    ii. in relation to the surplus, we expect NERL and/or the Trustee to manage the surplus effectively and efficiently in the best interests of current and future airspace users.

18. In circumstances where there is a surplus, we note that Section 10 of the DB Pension Scheme rules[15] vests dealing with any such surplus in NERL and not in

[15] Civil Aviation Authority Pension Scheme Trust Deed and Rules, NATS Section, Appendix 3 (NATS Rules), Section Part 1 – Administrative Provisions, para 10.2

the Trustee. We expect NERL to consult with the Trustee to decide the best way to manage such surplus (whether that is to de-risk the investment strategy, to reduce employer contributions, to pursue another course of action or to pursue a combination of several courses of action). We expect NERL to provide us with information on its preferred course of action, in particular to demonstrate how the interests of airspace users have been properly taken into account in selecting the way forward.

19. The DB Pension Scheme should be managed in a way such that the risk of any trapped surplus (a surplus that cannot be resolved through contribution holidays) is remote. We expect the Trustee and NERL to minimise the likelihood of any trapped surplus arising, which is likely to be achieved by a measured and balanced approach to de-risking alongside reduced contributions. We expect the Trustee and NERL to provide evidence on how they intend to minimise such risk, in particular any provisions (such as alternative funding options) in place to ensure that any surplus can be accessed and returned to the airspace users.

Section 2: Principles we propose to apply

Principle 6: Remuneration of future service cost and deficit repair contributions

20. We recognise that the funding of its pension liabilities is a legal obligation on NERL and hence a necessary cost of its operations. We also recognise that allowances for reasonable and efficiently incurred Pension Costs should be fully reflected in its pricing.

21. We acknowledge that Pension Costs projected for each control period are only estimates of the actual cost and will vary over time for various reasons, including for reasons outside NERL's control. As such, it is possible that the Pension Costs reflected in NERL's pricing will also need to vary over time.

22. Subject to NERL and/or the Trustee fulfilling their obligations and complying with the principles set out in this RPS, we commit to the continued full funding of reasonable and efficient future service costs and reasonable and efficient deficit repair contributions associated with NERL's Pension Costs by way of revenue allowances in relevant control periods.

23. Our funding commitment does not cover any element of the Pension Costs that are attributable to the activities of other entities within the NATS group which are outside the scope of NERL's Licence.

Principle 7: Pass through mechanism in relation to unforeseen and significant changes in the Pension Costs

24. The statutory regime which governs the funding of DB pension schemes requires actuarial valuations to be performed at least every three years. This is not aligned with the five-year reference periods, as defined in the EU Performance Scheme Regulation, which has been in place since Reference Period 1 (RP1)

commenced in 2012. As noted above, while the duration of the UK's regulatory periods are not yet determined, we note the requirement in the Eurocontrol Principles that reference periods cover a minimum of three years and a maximum of five years. As a result, the level of cash contributions that NERL is required to make to the DB Pension Scheme may vary from the allowances assumed in the performance plan/price control.

25. Pass-through is the regulatory mechanism that allows for any significant and unforeseen changes to the Pension Costs included in the performance plan/price control to be recovered from – or repaid to – to airspace users through NERL's prices.

26. Pass-through is permitted where the following criteria are satisfied:[16]

   i. the pension costs have been established and specified in the determined costs;

   ii. there are unforeseen and significant changes in those pension costs;

   iii. the changes result from unforeseeable changes in national pensions law, pensions accounting law or unforeseeable changes in financial market conditions;

   iv. the changes in the pension costs are outside NERL's control; and

   v. NERL has taken reasonable measures to manage the increase in pension costs.

27. We envisage that "*unforeseen and significant changes*" to Pension Costs efficiently incurred by NERL, which have arisen from "*unforeseeable changes*" in the laws and market conditions noted in sub-paragraph iii) above, would be eligible for the Pension Cost pass-through.

28. Whether a change is "unforeseeable" or "unforeseen", as appropriate, will need to be considered on a case-by-case basis and will depend on the circumstances at the relevant time. By way of demonstration of how we envisaged applying these terms, during the CMA reference of the RP3 price controls we provided two examples of circumstances when we thought determinations of future costs would and would not be subject to pass-through:

[16] Paragraph 3.3.4.2(c) of the Eurocontrol Principles.

- if the financial market returns and therefore required DB deficit costs at the 2020 valuation were in line with NERL's business plan costs, then the £18 million reduction we made to NERL's forecast costs at RP3 would be eligible to be funded through the pension cost pass-through, subject to checks that the costs are efficient and take account of offsetting cost savings that NERL has made. This follows from items (iii), (iv) and (v) at paragraph 26 above as the financial market conditions at the next pensions valuation are unforeseeable and outside NERL's control, and NERL needs to demonstrate it has taken reasonable measures to manage the increase in pension costs; and
- increases in costs that arise due to salaries and staff levels, for example, would not be eligible for pass-through as they are, in our view, "controllable" under item (iv) in paragraph 26 above.

Principle 8: stability of regulatory regime

29. The stability of the regulatory framework over the long term should provide the Trustee with greater confidence in NERL's ability to meet its legal obligations to support the DB Pension Scheme. For airspace users who bear these costs, this ensures appropriate levels of contributions through an efficient long-term funding objective and investment approach which retain an appropriate level of risk and return.

30. Assuming that NERL and the Trustee fulfil their obligations and subject to any changes in legislation, we commit to maintaining principles 6 and 7 above for the foreseeable future. We propose that any material changes to this policy would be subject to consultation with stakeholders, including airspace users, NERL and the Trustee, including in relation to the appropriate notice period for implementing any new arrangements or principles.

APPENDIX D

2020/2021 reconciliation and review

Introduction

1. In making its determination for RP3, the CMA concluded that it would be too difficult to properly assess the impact of Covid-19 and that we should review these matters when better information was available. It established price controls covering the period January 2020 to December 2022 and set out an expectation that a reconciliation exercise would be necessary for 2020 and 2021 with reference to actual flight volumes and costs over the period since the start of 2020.

2. This appendix sets out our initial views on the approach to the reconciliation review, outlines a framework for deciding on our approach invites stakeholder feedback on these and identifies next steps.

Our approach

3. As part of the reconciliation review we intend to establish the level of reasonable determined costs for NERL for 2020 and 2021.

4. There are a range of approaches to that could support this assessment:

   - at one end of the plausible range of approaches, we could require NERL to provide us with a detailed, business plan type submission that would enable line by line scrutiny of costs; and
   - at the other end of the range, we adopt a very light touch approach based on audited accounts for actual costs incurred in 2020 and updated forecasts from NERL for 2021.

5. There are also credible approaches between these two ‘bookends’, such as focussing on specific building blocks like operating costs and/or capital expenditure. Selecting these for further scrutiny could be based on their impact on user charges which would benefit in keeping the review focused. Similarly, we could use a variance analysis to direct where we might focus most attention, as it would allow us to identify and scrutinise the material variances in greater detail. This is similar to the approach used for the Independent Planning Cost Reviewer

(IPCR) of Heathrow Airport Limited's planning costs in relation to capacity expansion.[17]

6. We summarise four approaches in the table below.

No additional submission	Specific building blocks submission	Variance analysis – detailed submission	Business plan type submission
No submission – review based on audited accounts and updated forecasts to a similar level of detail.	Focus on specific building blocks such as operating costs and/or capital expenditure.	Variance analysis type of submission, enabling to scrutinise material variances in detail.	Very detailed, business plan type of submission, enabling line by line scrutiny of costs.

7. Whichever approach we use to conduct the reconciliation review, it will be important that NERL clearly sets out and provides appropriate evidence of how it has acted efficiently, given the circumstances and information available to it at the time.

8. The timing of the reconciliation review means that is will not be possible for NERL to provide data covering all of 2021 and so some (or all) will need to be on a forecast basis. We do not consider that it would appropriate and proportionate to reach definitive conclusions on costs that may be subject to change. Our initial view is that it would be necessary to revisit these forecasts and make any necessary adjustments as part of a future price controls review, though we welcome stakeholder views on this issue.

Selection criteria

9. To assess the most appropriate approach to the reconciliation review, we have identified three selection criteria, based on the Government's Better Regulation Principles and Framework:[18]

17 See for example, CAP 1651 guidance document published on our website: https://publicapps.caa.co.uk/docs/33/CAP1651_GuidanceCatB(APR2018).pdf

18 More information on Better Regulation principles can be found on our website: https://www.caa.co.uk/Our-work/About-us/Better-Regulation/

- proportionality: Is the policy package proportionate in helping us to fulfil our statutory duties?
- targeted: Does the approach adequately target any potential underlying inefficiency?
- transparency: Is the overall approach simple and transparent?

10. We consider that, of the approaches summarised in the table above, that 'No additional submission' and 'business plan type submission' would score poorly against the selection criteria. For example, in case of 'No additional submission', it is arguable whether we would be able to further the interests of users as required by our statutory duties under the TA00. Nor would it be transparent how we arrived at our conclusion of accepting NERL's costs as they are presented.

11. Conversely, requesting NERL to submit a 'detailed business plan type submission' and undertaking bottom-up analysis may score higher on transparency criteria. However, we consider that it would likely to score poorly on proportionality given in-depth analysis that would need to be undertaken.

12. Our initial view is that of the four approaches considered, those that focus either on specific building blocks or allow us to undertake variance type of analysis score best against the selection criteria. For example, variance analysis would allow us to focus on material items while also providing a level of detail that would allow adequate scrutiny of detailed individual costs, thus being targeted and proportionate. It would also provide a simple and transparent means of readily identifying those areas where we might wish to scrutinise specific costs in more depth.

Consultation Questions

13. Views are invited on any aspect of the approach to the reconciliation review, outlined in this appendix. In particular, we welcome feedback on:
    - the four possible approaches to conducting the reconciliation review discussed above;
    - the proposed selection criteria for informing the most suitable approach;
    - our initial assessment of the approaches; and
    - to what extent we should revisit our 2021 forecasts as part of a future price control review.

Next steps

14. Recognising the challenging timescales for the overall review discussed in chapter 3, we intend to publish a working paper in early 2021 setting out our evolving views and taking into account stakeholder feedback on this appendix.