

Economic Regulation of NATS (En Route) plc: working paper on the reconciliation review for NR23, including the request for information

CAP2291

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Background to this working paper

Introduction

1. In previous documents, we have committed to a reconciliation review of actual traffic volumes and costs for 2020 to 2022, given the significantly lower than expected traffic volumes over this period.¹ This follows the findings of the Competition and Markets Authority (“CMA”) in 2020, which stated that we should do this review, while also recognising that NERL’s current price control arrangements include an established mechanism for traffic risk-sharing (“TRS”).
2. We need to conduct this review in accordance with our statutory duties, taking account of a range of considerations including NERL’s financeability and the affordability of its charges.
3. In June 2021, we provided an update on our approach to the conduct of this reconciliation review that stated that, taking due account of stakeholder feedback, we planned to issue a request for information (“RFI”) to NERL in the Autumn of 2021.²
4. This document sets out how we have responded to stakeholders’ feedback on the June 2021 Update and provides the RFI in the appendix. We expect NERL to respond to the RFI with its business plan submission for NR23 that is due to be submitted to the CAA by 7 February 2022. We also set out information that we would expect to see as part of NERL’s building block submission for NR23 that is due to be submitted to the CAA in December 2021.
5. This working paper sets out:
 - stakeholders’ responses to the June 2021 Update and our views on these responses;
 - in the appendix, the RFI (which provides a high-level overview of the information we require to carry out the reconciliation review); and
 - a more detailed description of the evidence that is being sought from NERL as part of its submission for each building block.

¹ See, for example, NATS (En Route) Plc/CAA Regulatory Appeal – Final Report, August 2020 or our earlier response to CMA’s provisional findings on RP3, CAP 1910: [link to CAP 1910](#).

² See CAA, CAP2160, “Economic regulation of NATS (En Route) plc: further update on approach to the next price control review (“NR23”)”, June 2021 (the “June 2021 Update”). www.caa.co.uk/CAP2160.

Stakeholder responses to the June 2021 Update

June 2021 Update

6. In Chapter 3 of the June 2021 Update, we set out our proposed approach to the reconciliation review. We said that:
- the review will be carried out in 2022 after we have received NERL's business plan;
 - the review will set out to determine what an efficient level of costs was for 2020 to 2022, as the basis for recovery of traffic risk-sharing revenues through user charges in future years;
 - the review will be based on actual and forecast traffic and costs for 2020 to 2022, but we would not use the benefit of hindsight in assessing efficiency;
 - we will focus on reviewing NERL's most important building blocks and cost items. We identified particular building blocks that we would focus on and our latest view on these is highlighted in the 'Examples of detailed evidence' section of the RFI;
 - we would consult on licence modifications later this year to prevent automatic recovery of the revenue shortfall that would otherwise occur as a result of the traffic risk-sharing mechanism currently set out in the Reference Period 3 ("RP3") price control. At the same time, we would provide further details of the policy principles that will guide our approach to the recovery of traffic risk-sharing revenue from 2020 to 2022. We published this consultation on these licence modifications on 1 October 2021;³ and
 - we would publish an RFI for NERL in the Autumn of 2021 to gather the information required to support our reconciliation review.

Stakeholder responses

7. We received responses from the following organisations: British Airways, the CAA Consumer Panel, Easyjet, NERL, Prospect and Ryanair.
8. NERL agreed with our overall approach. On the scope of the review, NERL considered that pension costs should not be given the same focus as operational

³ See CAA, CAP 2245, "Economic regulation of NATS (En Route) Plc: consultation on licence modifications to implement exceptional measures", October 2021. Link to [CAP2245](#).

expenditure because pension costs are influenced by legislative protections and changes in market conditions more than the changes in staffing levels, and this review might cause uncertainty with the regulatory policy statement. NERL also requested greater clarity around the period over which the traffic risk-sharing revenues from 2020 to 2022 would be recovered.

9. Airline stakeholders broadly agreed with our approach. Some airlines recommended that the scope of the review should be expanded to include areas such as cost of capital, net book value of total assets and depreciation. In relation to the review of 2022 forecast costs, British Airways (“BA”) noted that there should be a true-up in 2023 when actual costs for the whole of 2022 are available.
10. Prospect, a Union, in its response considered that the review should be proportionate and should not question every decision made.

Our views

11. In considering our policy and responses received from stakeholders we have been guided by our statutory duties under the Transport Act 2000 (the “TA00”). The reconciliation review will look at the efficiency of NERL’s costs for the years 2020 to 2022 and we will do this in a manner we think is reasonable having regard to the secondary duties, including:
 - to further the interests of consumers;⁴
 - to promote economy and efficiency on the part of NERL; and
 - to secure that NERL will not find it unduly difficult to finance its activities authorised by the licence.⁵
12. We agree with the views expressed that the reconciliation review should be proportionate and should not question every decision made. We will also need to ensure that it is consistent with our statutory duties, taking account of a range of considerations including NERL’s financeability and the affordability of its charges.

⁴ We use the term “consumers” in this context as a collective term to cover operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them, being the parties whose interests we are required to consider by section 2(2)(a) TA00.

⁵ Section 2(2)(a)-(c) TA00.

13. Based on feedback from stakeholders, we have expanded the scope of this RFI to include items on cost of capital and financing. We will need to consider further which elements of the cost of capital should be included in the reconciliation, particularly where costs are not directly observable.
14. In response to BA's suggested use of a true-up in 2023, we note that we will be reviewing the efficiency of NERL's actual costs for 2022 once these are available. However, we consider that any intervention to account for any variances should be proportionate so that the benefits to consumers of conducting such a review clearly outweigh the costs involved.
15. We have also adjusted the scope of the review of pensions costs to focus on material changes and actions taken to reduce these costs during the period. Our approach will be consistent with the pensions regulatory policy statement,⁶ which recognises that there is a pass-through to charges for certain changes in pension costs and circumstances. As a result, we will look to avoid making adjustments to the efficient costs baseline that would double-count adjustments made through this pass-through. A detailed review of valuation assumptions and pension costs, to ensure they are reasonable and efficiently incurred, will be carried out on a forward-looking basis during the NR23 review. We do not plan to revisit those assumptions used for RP3 on a retrospective basis.
16. As part of this review, in line with our duty to promote economy and efficiency, we will be considering the efficiency of NERL's capex. This may affect NERL's regulated asset base ("RAB") and depreciation in NR23 on a forward-looking basis. Therefore, we do not consider that an additional backward-looking review of the net book value of total assets and depreciation is needed for the period 2020 to 2022 and so we have not added these to the scope of the review.

⁶ See CAA, CAP 2119, "Economic regulations of NATS (En route) plc: Update on approach to the next price control review", March 2021. Link to [CAP 2119](#).

APPENDIX A

Request for information for the reconciliation review

Overview

- A1 This appendix contains the RFI, setting out the information we expect NERL to provide for the purpose of the reconciliation review.
- A2 We expect NERL's submission of information for the reconciliation review to set out in detail its actual/forecast cost baseline for the period 2020 to 2022, and the relevant underlying costs and cost drivers. NERL should show and explain the main differences between its actual/forecast costs and costs allowed in the CMA determination in each year.
- A3 As a minimum, we expect the cost data to be broken down by each building block. But in many cases, it will be necessary to provide a further level of detail to show how these cost building blocks have been built up from more detailed cost lines and the drivers behind increases or reductions in costs (such as quantifying the impact of the Government's furlough scheme and NERL's voluntary redundancy programme).
- A4 NERL should provide all relevant evidence that is required by the CAA to undertake its review of the efficiency of the revised baseline for 2020-2022. Where there are follow-up questions on this evidence or gaps in the NERL data submission, the CAA and its advisors will seek further supporting evidence, in relation to specific cost items. That said, we are not seeking exhaustive detail on every building block and expect the submission to be proportionate and appropriately focused.
- A5 While not intended to be exhaustive, we set out below at a high level the types of information and evidence that we expect NERL to provide:
- i. an explanation of how it responded to the dramatic fall in traffic caused by the impact of the covid-19 pandemic and why this was efficient in the circumstances and given the information available to it at the time;
 - ii. details of the key management responses and decisions, which other options were considered and rejected, and how the preferred option was selected (e.g. by submitting meeting minutes or slides);
 - iii. justification for any short-term increases in operational and financing costs and calculations showing the benefits and longer-term cost savings to consumers and airspace users of those increases;

- iv. an explanation of what further cost reductions could have been made but which were not implemented as they would not have been in the interests of consumers based on information available at the time the decision was made;
- v. the main assumptions used to forecast traffic and costs in 2022 (and, if necessary, 2021). Where actual traffic levels and costs are not yet available, NERL should indicate the extent of the uncertainty around these forecasts;
- vi. internal and external benchmarking information, particularly information that was taken into account when making decisions, showing how NERL's decisions compared with relevant comparators (such as other ANSPs, airports and airlines) and relevant historical observations; and
- vii. any other relevant analysis and evidence that was relied on for making management decisions.

A6 NERL should set out its proposed approach to the reconciliation and recovery of traffic risk-sharing revenues for the period 2020 to 2022, based on its assessment of the efficient cost baseline and the policy principles we set out in the October 2021 licence modification consultation.

Examples of detailed evidence

A7 In the following paragraphs we outline some of the areas where we expect NERL to provide detailed evidence with its reconciliation submission. This is a non-exhaustive list and NERL is welcome to submit any other evidence it considers relevant.

A8 On **opex for UKATS and Oceanic**, NERL's submission should provide details of:

- the options considered and decisions made on staffing levels and costs, staff training and non-staff costs for the 2020 to 2022 period and over the longer term;
- details of training courses for ATCO staff, historically and planned, including start dates, any suspensions or cancellations of the courses due to COVID-19, pass rates and associated unit costs;
- the use of government support schemes and the quantified impact of these on NERL's costs for 2020 to 2022. Consumers should not be expected to pay for costs covered by any of these schemes;
- the use of internal processes such as voluntary redundancy, part-time working and freezing recruitment, with calculations showing the corresponding benefits and costs of each;

- staffing levels, costs, training costs and mitigation actions (such as early retirements, use of furlough, reduction in overtime and all other mitigation actions taken) should be broken down by NERL staff category – ATCO, ATSA, engineers, etc;
- detailed breakdown of non-staff operating costs, using the breakdown provided during the RP2/RP3 analysis of operating costs: including on maintenance, other facilities costs, utility costs, IT costs (operational and non-operational), rent and rates, asset management, catering, business support, etc;
- values of any operational parameters that are considered by NERL to be key drivers of staff opex and non-staff opex costs, and any cost sub-categories as set out in the previous bullet point. This should include IFR movements, TSUs, energy usage (MWh), facilities size (square metres), and asset values;
- a description of actions taken to mitigate or renegotiate, or were not incurred (e.g. travel costs) for non-staff cost items, by line item, recognising the lower levels of operational activity and use of assets and systems as compared to 2019; and
- the use of any other schemes or funds, such as the opex flexibility fund to support delivery of airspace modernisation activities.

A9 All operating cost lines, and drivers (staff numbers, overtime, training, activity levels, operational parameters) should present the equivalent actual value for 2018 and 2019.

A10 In addition, NERL has explained that some of its decisions were driven by the requirement to retain liquidity / cash reserve levels at adequate levels. It would be helpful for evidence from balance sheet and cash flow statements to explain how cost containment measures interact with delayed income from under recovery, additional loans, government support and cash reserves to maintain the liquidity requirements of the business.

A11 We also want to understand NERL's forecast of activity recovery during 2020 and 2021, meaning when were activity level forecasts refreshed/ changed and how these drive and link to decisions covering short-term and medium-term actions.

A12 On **capex for UKATS and Oceanic**, we expect NERL to provide information on its strategy and, in particular:

- the impact of the covid-19 pandemic and consequent collapse in air traffic on the delivery of programmes of strategic importance in RP3, such as airspace modernisation, DSESAR and others within RP3;

- the impact of changes in delivery on costs (e.g. whether NERL stopped incurring costs immediately, or whether there were any ongoing costs);
- changes in planned capex, by line item, forecast (pre-2020) and actual 2020 to 2022, with an explanation of amendments to the timing of implementation and costs as a result of mitigation actions (e.g. delays, costs of stopping projects, etc.);
- additional costs incurred in delivery of NERL's capital programme due to stopping and/or pausing projects;
- any transfers of costs between opex and capex, including impacts of the capitalisation of opex;
- the impacts (both actual impacts so far and expected impacts) of capex programme decisions on both service quality and the benefits delivered to consumers;
- any measures taken or planned in relation to the capex programme to increase the scalability (both downwards and upwards) of operations, including impacts of such measures on capex and opex; and
- the impact on the timing and costs of the future capex programme.

A13 On **pension costs for UKATS and Oceanic**, we expect NERL to focus on material changes to its costs, including:

- material changes to NERL's ongoing defined benefit ("DB") and defined contribution ("DC") scheme pension costs, for example given changes to staffing levels;
- any changes in costs that will be made through the pension cost pass-through so should not be reflected in the efficient cost baseline to avoid double-counting; and
- any actions taken to reduce DB and DC scheme costs in the short-term, such as through contributions holidays.

A14 On **financing costs, cost of capital and tax**, we expect NERL to provide information on:

- its proposed approach to the recovery of any additional costs relating to its recent debt refinancing and why these should be recovered from consumers. This includes setting out:
 - a) the full costs of refinancing, including arrangement fees and any payments under Spens clause;

- b) description of debt refinancing and why the particular approach was taken (including, but not limited to, the choice of tenor and use of bridging loans); and
 - c) calculation of the resulting reduction in financing costs that will be faced by consumers over the longer-term and any other quantitative and qualitative benefits to consumers;
- comparison of the actual and allowed tax costs, including consideration of the impacts on tax costs from lower than expected revenues and NERL's higher than expected level of gearing in 2020 to 2022.

Next steps

- A15 We should receive NERL's full submission on the reconciliation review together with its NR23 business plan no later than 7 February 2022.
- A16 Given our experience conducting ex-post reviews and the relatively compressed timeline for this review, we propose including several additional steps within the process.
- A17 Firstly, we encourage NERL to provide us with its initial view of its efficient cost baseline, reconciliation of TRS revenues and with a high-level narrative ahead of its full submission. For example, this could be submitted with the building block update which we should receive by 10 December 2021. This would help us in focusing our analysis, identifying early in the process any areas that are complex and identifying where additional information may be required in the February 2022 business plan submission.
- A18 Secondly, we suggest workshops with NERL to discuss this RFI and after NERL's building block update in December 2021 for us to explain our feedback on NERL's initial view and where additional information may be required in the February 2022 business plan submission.
- A19 We are open to discuss with NERL any questions it may have on how it should best respond to this RFI.