

Request for further information to NERL for the NR23 Business Plan submission: cost and revenue building blocks

CAP2306

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Purpose and background

1. This document sets out the CAA's request for further information (RFI) and detail in relation to the operating expenditure, capital expenditure and non-regulatory revenue building blocks to be included in NERL's NR23 business plan, which we expect to be submitted by 7 February 2022.
2. This is to support the CAA, and its consultants, in assessing the efficiency of NERL's costs and non-regulatory revenue forecasts for the NR23 period (1 January 2023 to 31 December 2027). This guidance does not include other building blocks, like pensions costs, depreciation and cost of capital, where NERL should refer to our previous guidance in terms of what should be included in its business plan.

Background and context

3. The CAA is the economic regulator for NATS En Route plc (NERL) in accordance with a licence issued to NERL under the Transport Act 2000 (TA00). This licence includes conditions relating to prices, service quality and financial and operational resilience, amongst other things. The CAA monitors compliance with NERL's licence and has powers under the TA00 to issue enforcement orders to rectify a breach of the licence.
4. As part of this role as economic regulator, the CAA sets the price control conditions in NERL's licence which constrain the charges that NERL can apply to the provision of its services. In August 2019, the CAA published its final decision on the terms of NERL's price controls for the five year period from 2020 to 2024 (known as Reference Period 3, or RP3).¹ NERL rejected the CAA's proposed licence modifications and in November 2019 the CAA made a reference to the Competition and Markets Authority (CMA). During the period when the CMA was considering the reference, covid-19 emerged as a pandemic, with the resulting severe and unprecedented downturn across the aviation sector.
5. The CMA established price controls covering the period January 2020 to December 2022 and decided that due to the uncertainty created by covid-19, we should review the price control to take account of the impact of the covid-19 pandemic when better information had become available. The CMA said a reconciliation review would be appropriate with reference to actual flight volumes and costs over the period from 2020 to 2022, with the new price control set to start in 2023 or before.

¹ [CAP1860](#)

6. In June 2021, we published an update on our approach to NR23, setting out our view on the timetable for the review, guidance for NERL in developing its business plan and the engagement process with stakeholders; and our intended approach to the reconciliation of NERL's revenues for 2020 to 2022.²
7. The business plan guidance in the June 2021 document set out that we expect NERL to develop different scenarios given the current high level of uncertainty facing the sector over future traffic forecasts. We expect NERL to develop a plan that is well-integrated between traffic levels, costs and service levels, is flexible and robust under different scenarios, and shows the trade-offs and options that it has considered.
8. In November 2021 we published a working paper on the reconciliation review for NR23.³ This included our views on stakeholder responses and a request for information to NERL, which provided a high-level overview of the information we require to carry out the reconciliation review for 2020 to 2022, and a more detailed description of the evidence being sought from NERL as part of its submission for each building block.

² [CAP2160](#)

³ [CAP2291](#)

Detail we expect to see in the business plan for cost and revenue building blocks

Overview

9. We expect NERL to provide a clearly-structured submission that sets out in detail its forecast costs and non-regulatory revenues for the period 2023 to 2027 under different scenarios, along with the relevant underlying costs, cost drivers and revenue drivers. At a minimum, we expect the data to be broken down by each building block. 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.
10. Data provided should cover historical costs and revenues (2015-2020), actual/historical costs and revenue for the remainder of the reconciliation period (2021-2022), and forecast costs and revenues for the NR23 period (2023-2027). To support the understanding of its forecasts, where relevant NERL should demonstrate how its forecasts for the NR23 period relate to trends in historical data and the reconciliation period.
11. Where available, NERL should also provide forecasts for cost and revenues in future regulatory periods (e.g. 2028-2032). The purpose of this is to allow the CAA, and stakeholders, to understand how NERL's plans for the NR23 period fit into a longer-term strategy, in particular around longer term capex investments that span regulatory periods. This information will allow the CAA to understand whether the costs forecast within the NR23 period are reasonable and efficient. We recognise that longer-term forecasts may be at a higher level of detail than the NR23 data and subject to a lower level of quality assurance.
12. NERL should provide clear evidence that allows us to carry out an effective and proportionate review. NERL should provide all supporting evidence that it considers to be relevant to assessing the efficiency of its costs. That said, we are not seeking unnecessary detail and we expect the submission to be proportionate and appropriately focused, with a clear structure and the appropriate signposting of all the main information. Further detailed information should be provided in appendices, with a clear description of the purpose and content of each appendix.
13. The guidance in the June 2021 document set out five principles that NERL is expected to take into account in developing its business plan. We expect NERL to provide relevant information and evidence in line with these five principles:

- **Principle 1:** NERL’s business plan should be based around a plausible range of scenarios, which have been developed through engagement with airspace users and other stakeholders. Where possible, these scenarios should be agreed with users.
- **Principle 2:** NERL should provide robust supporting evidence for its opex and capex plans, including: the key drivers, how the costs link with each other and to the traffic and service level forecasts, what other options and trade-offs it has considered and rejected, and how programmes might need to evolve if circumstances change.
- **Principle 3:** NERL should demonstrate clear links between costs and service outcomes for each of the business plan scenarios.
- **Principle 4:** in addition to its work on scenarios, NERL should consider how the uncertainty due to the impact of the covid-19 pandemic should be mitigated and managed effectively in the interests of consumers.
- **Principle 5:** NERL’s business plan should be customer and consumer focussed. It should demonstrate how NERL has developed its business plan through transparent, meaningful and effective engagement with its customers and taken proper account of consumers’ interests.

Examples of detailed evidence

14. In the following paragraphs we outline some of the areas where we expect NERL to provide detailed evidence with its business plan submission.
15. We are requesting this evidence to enable us and our advisors to assess whether the costs (and non-regulatory revenues) in NERL’s business plan are efficient and consistent with NERL meeting its statutory obligations, including safety, and delivery a high quality of service to its users and consumers. Where appropriate, we have explained why we are requesting specific information.
16. We intend to work with NERL ahead of the business plan submission to interpret and develop the specific requirements below in a way that best supports the production of a high quality business plan, for example by agreeing alternative ways in which it could fulfil our requirements.
17. In light of ongoing uncertainty over traffic volumes due to covid-19, we and our advisors need to be able to take a view on whether NERL’s plan is robust to potential significant changes in traffic before and during the NR23 period. NERL’s submission should be sufficiently detailed to enable stakeholders and the CAA to understand how service levels and the cost building blocks would vary under a range of reasonable alternative traffic scenarios around the central case. NERL should explain what key options it would consider under alternative traffic scenarios, and how it would make trade-offs, by providing details of:

- a) The traffic forecasts considered under alternative scenarios, including factors that may have an impact on traffic recovery and demand for air traffic services (e.g. the potential effect of restrictions on international travel, likely future capacity or constraints).
- b) Other key factors for NERL's NR23 investment programme, such as airspace modernisation.
- c) The levels of operating expenditure, capital expenditure and service quality planned, including evidence on risks and contingencies.
- d) How these outcomes correspond to the needs/priorities of consumers and airspace users, and/or environmental benefits.
- e) What other options and trade-offs it has considered and rejected for each building block.

18. NERL should take account of the CMA's guidance that:

"NERL's engagement with users on risks associated with its capex plan should include explicit attention being given by NERL to identifying the opex effects that may be associated with different changes to that plan, and different options with respect to how NERL might respond".

19. **On opex for UKATS and Oceanic**, NERL's submission should provide details of the key variables that will drive costs, including:

- a) The assumptions linking traffic, service delivery and costs.
- b) Evidence to demonstrate the efficiency of its cost forecasts, including benchmarking undertaken and detailed explanations of the impacts of different initiatives (particularly where step changes are introduced).
- c) Detailed projections for staff numbers, staff salaries, other employment costs (including pensions), and staff productivity (by the categories specified in the template issued alongside this request).
- d) Activity and staffing plans supporting the cost forecasts (including overtime, training).
- e) Detailed projections for non-staff costs (by the categories specified in the attached template).
- f) Values of any operational parameters that could reasonably be considered to be key drivers of staff opex and non-staff opex costs (and any cost sub-categories as set out in attached template) under each scenario. These should include instrument flight rules (IFR) movements, total service units (TSUs), energy usage (MWh), facilities size (square metres), and asset

values (gross book value). Supporting narrative to explain the links between the drivers and costs should be provided.

- g) Evidence of the approach to cost allocation between UKATS and Oceanic, and between regulated and non-regulated activities for any central costs or common costs. We expect NERL to explain what approach it has used (including if it has continued to use the approach used at the RP3 review) and provide evidence around how this approach has been implemented in practice linked to the numbers shown in the business plan.
- 20. Costs should be presented in nominal terms and in real terms (2020 price base). NERL should provide the inflation assumptions used in its forecasts. NERL should provide evidence to support any assumptions of real price effects, such as where alternatives to CPI or RPI have been used to measure cost inflation.
 - 21. All relevant information should be presented in calendar years.
 - 22. Costs, non-regulatory revenues and key drivers should be presented as a timeline for the period 2015 to 2027 (and beyond where available). Data should be comparable over time and across regulatory periods. If there are differences between different submissions (e.g. a change between the building block update and the full business plan), NERL should provide a reconciliation of these differences for any overlapping periods.
 - 23. Complementing the reconciliation review of 2020-2022, NERL should provide a narrative explanation of how its business plan has been affected by and responds to actions taken during this period. For example, it would be helpful for NERL to provide evidence and explain (where relevant) how the business plan reflects actions to maintain liquidity and change the timing of investments.
 - 24. **On capex for UKATS and Oceanic**, we expect NERL to provide information and evidence on its strategy and its investment portfolio to show that costs have been estimated in a way that is efficient and reasonable, including:
 - a) The list and descriptions of the investment programmes/items, as detailed in the Service and Investment Plan (SIP). Information about each investment programme/item should include the planned total value of the asset, options appraisal undertaken in support of the each investment programme / item, the planned lifecycle of the asset (amortisation period), the planned entry into operation of the asset, the allocation of the asset to the different services (namely Oceanic and UKATS en-route).
 - b) Capital expenditure per investment programme/item per calendar year, starting from 2015 to 2027 (and beyond where available), including planned and actual data for years in which actuals are available. Where NERL draws on historical information previously provided in SIP documents without repeating it, it should clearly reference, within the business plan,

where this information can be found, and should ensure totals reconcile (or are reconciled within the business plan – for example if price bases differ). If any reconciliations are done in the business plan, NERL should detail its assumptions (for example in terms of price indices used).

- c) Where appropriate, the estimated impact of investment programmes/items on maintenance and operational costs: any additional maintenance requirements or otherwise savings in maintenance and operational costs.
- d) Identify where capital expenditure will be avoided through the purchase of external services and the corresponding impacts on operational costs.
- e) The expected impact of each investment programme/item on service quality, capacity, environmental performance, safety, or any other element of performance, including, but not limited to, the relationship between the capital expenditure proposed and benefits from improvements in 3Di, capacity and other performance metrics. Benefits/disbenefits should be expressed in terms of the relevant metrics impacted (e.g. full time employees (FTEs), delay minutes, tonnes CO₂), as well as in monetised figures where appropriate. Any calculations/estimations of benefits/disbenefits should be subject to sensitivity analysis in terms of traffic volumes, where appropriate. Assumptions used for the calculation/estimation of benefits should be disclosed.
- f) For investment programmes/items where this is available, the level of Air Traffic Control Officer (ATCO) involvement for each year, for definition, testing, validation, and training related to the investment programme/item.
- g) Any dependencies, linkage between investment items in the portfolio. Ideally a critical path analysis should be presented for the investment portfolio, highlighting the main bottlenecks, critical items/projects.
- h) For each investment programme/item, the links to ICAO Global Air Navigation Plan/Communications Panel/Interoperability or any other regulation and/or the European ATM Masterplan. References should be made to ATM functionalities, sub-functionalities, and families thereof at the minimum (or to operational improvements, if possible).
- i) Any plans for actions to transform system elements to services, or in any other way to transition towards a more service-oriented architecture, or in any other way transform capex into opex (or vice versa).
- j) For each investment programme/item, the planned actions to mitigate negative impacts in case traffic recovery is prolonged and/or in case of a future dramatic downturn in traffic.

- k) Investments and/or actions planned to improve scalability of operations (both upwards and downwards).
- l) Detailed description of any joint investments, cooperation with other Air Navigation Service Providers (ANSPs) or other partners, including the realised and expected benefits of these, compared to other options.
- m) Scenarios as to how to refocus/reprioritise investments in case major changes in the underlying assumptions (such as traffic, raw material prices and availability, ATCO availability, salaries, etc.).

25. On **non-regulatory revenues**, we expect NERL to provide an overview of its strategy and:

- a) A break-down of the non-regulatory revenue streams for NR23, at a level of detail at least equivalent to what was provided to our advisors and to the CMA for the purpose of the RP3 review.
- b) A break-down of the costs associated with each non-regulatory revenue stream for NR23, supported by an appropriate method for allocating costs across Regulatory Service Lines (RSLs). We expect NERL to explain what approach it has used (including if it has continued to use the approach used at the RP3 review) and provide evidence around how this approach has been implemented in practice linked to the numbers shown in the business plan.
- c) Any updates to policies and procedures for intercompany trading within the group.
- d) Any updates on contractual agreements made by NERL, for example in relation to the Ministry of Defence (MoD).

Next steps

26. We expect to receive NERL's full submission on its NR23 business plan together with the reconciliation review no later than 7 February 2022.
27. Given our experience conducting business plan reviews and the relatively compressed timeline for this review, we have including several additional steps within the process to support our review.
28. Firstly, NERL has provided us with its initial view of its business plan building blocks and its approach to presenting scenarios, along with a high-level narrative in its building block update, on 10 December 2021. This is intended to 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 business plan submission by 7 February 2022.
29. For the 10 December update, we asked NERL to fill in the attached opex template in relation to historical data (i.e. up to 2021). Where possible, we would welcome data submitted on a forward looking basis soon after the 10 December 2021 submission, and will discuss this request with NERL. In any case, we require the forward looking data in the opex template to be provided no later than 7 February 2022 with the full business plan.
30. Secondly, we suggest workshops with NERL to discuss this RFI and after NERL's December 2021 building block update, for us to provide our feedback on NERL's initial view and where additional information may be required in the February 2022 business plan submission.
31. We are open to discuss with NERL any questions it may have on how it should best respond to this RFI.