

NERL response to the CAA's further update on NR23 (CAP 2160)

15 July 2021

NATS

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Summary

We welcome the CAA's further update to its approach to NERL's price control review from 2023 to 2027 ("NR23") in its consultation document CAP2160¹.

It is clear to us that the CAA has listened and responded to stakeholders' feedback, including our own. We are grateful for the flexibility the CAA has shown in its timetable in relation to the timing of its consultant studies. We believe that delaying the start of their work until 2022 will help us to create a higher quality business plan this year that reflects feedback from our customers.

However, the NR23 timetable remains a challenging one, with NERL still being required to complete its business planning process in half the time taken in previous price control reviews. It is essential that all stakeholders have realistic and pragmatic expectations about the contents of NERL's NR23 business plan.

We recognise the importance of discussing with our customers the options for the NERL business under different traffic scenarios, especially given the significant ongoing current uncertainty about the pace of recovery in aviation. However, it will not be possible for NERL to compile multiple detailed business plans using a bottom-up approach in the time available. One key determinant of NERL's costs in the core NR23 business plan will be the CAA's requirements for high service levels and low resilience risk at a granular level, as set out by its findings from the Palamon investigation. This will limit the options that NERL can put forward in its business plan in terms of trade-offs.

We welcome the support from the CAA to our customer consultation to date. We are ready to support our customers to make this process as successful as possible. We believe that we have put a plan in place that allows us to provide relevant information to customers in a timely fashion and for them to discuss our proposals with us for NR23.

We support the development in the CAA's thinking on its approach to the reconciliation review from 2020 until 2022. We look forward to the CAA's update on its principles for the recovery of our revenues during the 2020 to 2022 period in the autumn. Greater clarity about the CAA's intended approach in this important area will determine whether the NR23 regulatory period is set up for success as well as our shareholders' ongoing confidence in the business.

¹ CAA 2021, Economic regulation of NATS (En Route) plc: further update to the next price control review ("NR23"), Economic regulation of NATS (En Route) plc: further update on approach to the next price control review ("NR23") (caa.co.uk) (accessed 23 June 2021)

1. Timetable

- 1 This chapter responds to the timetable proposed by the CAA in Chapter 1 of its further update document for NR23.
- 2 We welcome the CAA's proposals to:
 - > defer their scrutiny of our costs through consultancy studies from the second half of 2021 until the first half of 2022; and
 - > delay the deadline for our business plan from end of December 2021 until early February 2022.
- 3 We have highlighted to the CAA that preparing our five-year business plan and engaging effectively with our customers in relation to it will be particularly challenging for this regulatory period given the current uncertainty and resource constraints in the aviation sector. While these changes help with the timetable challenge, they do not eliminate it. We agree with the CAA's description of the process as remaining "tight". We will still be completing our business plan process in half the time taken in previous regulatory reviews. This makes it essential that there are realistic and pragmatic expectations by the CAA and other stakeholders about the contents of NERL's NR23 business plan, which is discussed in the next section about the CAA's guidance.

1.1. Consultant studies

- 4 The important work of engaging with the CAA and its consultants to explain and justify NERL's efficient level of costs retrospectively will be undertaken by the same team who will be developing the business plan for NR23 and its supporting evidence. Time spent with the CAA's consultants would mean less time spent preparing our NR23 business plan, including our discussion with customers about it. We believe the delay to the consultant studies will help NERL to prepare its business plan, engage effectively with its customers on it and to reflect their feedback.

1.2. Business plan submission

- 5 In exchange for delaying the submission of our NR23 business plan by a month to early February 2022, the CAA has asked to receive our NR23 business plan data earlier, in mid-December 2021, instead of at the end of December 2021.
- 6 While this change means we will have to submit our NR23 business plan data earlier than the full narrative plan, including our explanation of key areas, we believe this is the right trade-off. In particular, the extra time for submitting our full business plan will give us a greater opportunity to organise the evidence that supports our business plan in an intuitive and accessible way to the CAA. Therefore, we support this approach.

1.3. Licence changes

- 7 In order to allow NERL and the CAA time for their processes for NR23, the CAA is proposing that it changes NERL's Licence after the start of NR23, instead of beforehand. Weighing up the pressures of this process, this seems a reasonable approach.

2. Guidance

8 This chapter responds to the guidance that the CAA has provided on preparing our business plan for NR23 and consulting our customers about it.

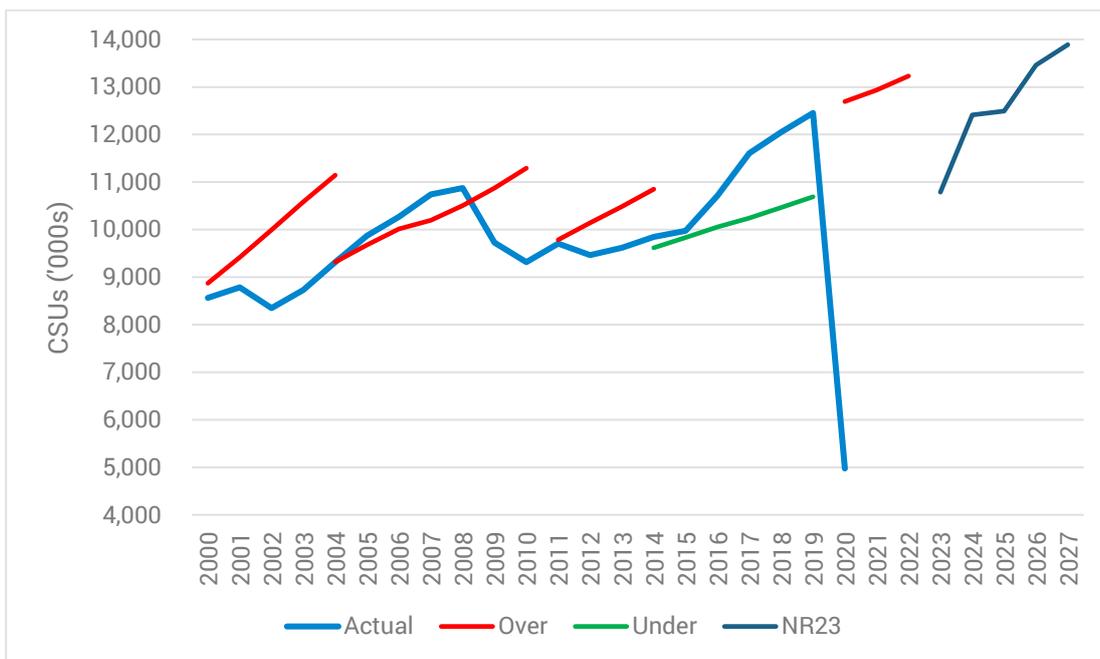
2.1. Business planning

9 The CAA has proposed five new guiding principles for NR23, which are additional to those in place for RP3. These extra principles are focused on mitigating the effect of uncertainty faced by the aviation industry as NERL prepares its business plan for NR23. NERL supports many elements of these principles, including the use of scenarios and agreeing them with its users, where it is possible to do so.

10 We recognise the importance of uncertainty mechanisms for NR23 compared to previous regulatory periods, given the greater levels of recent and prospective uncertainty. NERL's current regulatory framework has proven, in practice, to be robust and has ultimately withstood a shock of significantly greater magnitude than anything envisioned at the time of its creation.

11 Chart 1 illustrates the scale of the Covid-19 impact compared to other trends and shocks in the aviation industry for each regulatory period since 2000. Red lines denote where actual traffic was less than the forecast, which has happened every regulatory period apart from one (RP2, 2015-2019) and more often than not by a significant amount. The green line indicates the RP2 period where actual traffic was above forecast. This suggests a potential bias towards optimism in forecasts, which might require a cautious approach as a counterbalance for NR23 planning.

Chart 1: en route actual versus forecast traffic for NERL over past regulatory periods



Source: CAA traffic forecasts adopted for each previous review and STATFOR May21 extended base case for NR23 period

- 12 It may be, however, that further modifications could help in achieving the CAA's duties towards users' interests in a safe, cost effective service and towards NERL's sustainable financing. Such changes could be relevant if traffic recovery were materially slower than currently forecast or if there were a further demand shock in the period to 2027. It remains an open question whether, as yet, the current regulatory framework is capable of accommodating all plausible scenarios in addition to the Covid-19 shock. We will work with the CAA and other stakeholders over the coming months to explore the scope and design of uncertainty mechanisms which may be most appropriate for the circumstances faced by NERL and its customers. One important consideration will be unintended consequences, which could be material with significant changes in an uncertain environment.
- 13 In advance of those three-way discussions about uncertainty mechanisms, it is relevant to note that NERL's Licence conditions do already provide for variations in NERL's service performance based on the resources made available to it as part of the regulatory settlement. Specifically, in NERL's view, Condition 2 of the Licence provides that the level of service that NERL is required to provide is determined on the basis of capacity to be made available in accordance with the Service and Investment Plan ("SIP").
- 14 The SIP can and should provide an important means by which the CAA, NERL and customers can understand the interlinkages between the periodic regulatory settlement and NERL's day-to-day operational resilience. The absence of a clear understanding of this interlinkage, risks the development of a disconnect between: (a) the levels of operational resilience built into NERL's economic settlement at the outset of a reference period; and (b) the level of operational resilience that may subsequently be demanded by the CAA to be achieved by NERL during the reference period. This is particularly a risk in NR23, as traffic will remain uncertain and airlines are likely to prioritise cost-reductions over operational resilience in the short-term, while traffic recovery is predicted in the medium-term, thereby giving rise to similar economic incentives as were present during the development of the RP2 settlement. NERL is committed to better communicating how the capacity made available in accordance with the SIP correlates to the economic settlement and how it affects short-term and long-term operational resilience. This will ensure that this mechanism is recognised and also provides transparency to customers on the challenges and consequences that variations in SIP assumptions create for day to day operational resilience.
- 15 The CAA's guidance is that NERL's business plan should be based around a plausible range of scenarios, developed through engagement with airspace users. However, in the timeframe available, NERL will only be able to construct a single five-year business plan that is based on rolling forward sensible assumptions to deliver our core licence and statutory obligations. We highlighted that this is the only practical approach that is possible in our response to the CAA's March update document². The extra month the CAA has given us to submit our NR23 business plan does not facilitate any change from this approach because we will still be constructing the plan in half the time taken in previous review processes. It is unrealistic in the time available to expect that we could prepare multiple different business plans on a bottom-up basis. Instead, we will work with users to agree sensible variations on the NR23 business plan that uses a base traffic forecast. These variations will contain:

² NERL 2021, *NERL response to CAA consultation CAP 2119*, NERL response to CAA consultation CAP 2119 (accessed 23 June 2021), p. 9

- > options for different traffic scenarios;
- > options for phasing, over time, the recovery of NR23 determined costs and the 2020-22 traffic risk sharing revenue to address users' interests in the profile of charges as well as ensure our ongoing financeability; and
- > our assessment of changes in efficient operating and investment costs for each traffic scenario, including trade-offs.

- 16 In relation to the staffing resilience of the NR23 business plan, CAP 2160 draws attention to recommendation 1 of the CAA's Palamon investigation. It asks us to "...provide a **resilient** service that is capable of satisfying a range of reasonable scenarios for a rebound in traffic demand **for the various areas of its regulated air traffic services**" [emphasis added]. The requirement to maintain a level of resilience within particular areas of airspace within the network is an evolution from our understanding of our Licence requirements when we proposed our business plan for RP2.
- 17 For RP2, we planned to use overtime to cover gaps between demand and supply in our operational staff in order to minimise the expected costs of our service to customers while maintaining a safe and resilient service. We judged that this was an acceptable approach, given the goal of delivering the cost saving asked of us by the CAA and airlines, as long as we were meeting our delay targets for the network overall. In explaining its conclusion that NERL was in historical Licence breach, the CAA highlights the importance of having a "*recovery plan that...closed the gap on supply of ATCOs... in the near future*"³. However, it remains uncertain as to what NERL is expected to achieve in terms of sector-specific delay performance in order to avoid being found in breach in the future.
- 18 The CAA has so far not provided a quantitative benchmark as to the level of localised delay capable of constituting a breach, against which NERL could plan and manage its operations with more certainty. In the absence of this, what is needed is a clear framework setting out prospectively what the expectations are in terms of localised delay, how the steps NERL takes to meet those expectations will be assessed, and what factors or metrics (set out in the SIP or otherwise) will be used to assess the reasonableness of NERL's response.
- 19 Nonetheless, the Palamon decision itself and its associated recommendations provide a key guide as to how the CAA will apply the principles set out therein. NERL is committed to working with the CAA and airlines to implement the Palamon recommendations and to foster the new and better mutual understanding of the nature of NERL's obligations in this regard that is needed. Practically though, NERL must now assume that NATS-attributable delay at the local level is an important factor according to which NERL must plan its operations, especially in relation to staffing. This is in addition to its network-wide obligations. We interpret this as meaning that we should not plan to operate with a sustained gap between operational demand for ATCOs and supply during the NR23 period for any areas of airspace.
- 20 This is likely to have a detrimental impact on the flexibility NERL would otherwise have in terms of how it manages sectors of airspace across the network, which has been an important tool that NERL has used (and continues to use) to ensure it can fulfil its licence obligations in terms of the most expeditious flow of traffic across the network as a whole. Practically, the lead times in training ATCOs of three years or longer mean that we cannot readily flex the size and shape of our

³ CAA 2021

controller workforce to match closely the uncertain pace and pattern of demand as the aviation sector recovers. As such, NERL expects this to have staffing and cost implications, to ensure that our operations are sufficiently geared towards achieving expected levels of service resilience at a local and national level. This focus on resilience at the local level inevitably means a higher total cost for NERL running its operation overall. It means that we will have ATCOs in excess of demand in the early part of NR23 as traffic builds back. The timing of restarting the training college as well as the size of cohort to train will also be affected.

- 21 We are responding to the CAA's request to ensure that our NR23 business plan is informed by evidence from passengers on which outcomes are important to them, as a complement to evidence from our customers on their priorities. Based on feedback from other regulated companies about their experience of engaging with end customers and recognising that some passengers might not be aware of the service performed by NERL during their journey, we intend to supplement the CAA's suggestion of a passenger survey with some focus group activity. This extra task should enhance the value of the survey by helping to ensure we are asking the right questions of passengers in the survey and that we interpret their responses correctly.
- 22 In relation to new airspace users (such as drones and space launches), we agree with the CAA's guidance that we should be clear in our NR23 business plan about what activities we plan to carry out and how much we anticipate they will cost. NERL and NATS more broadly stand ready to support the CAA and the Government in helping to create a safe and effective framework for the best productive use of the UK's airspace, enabling a wider range of users and activities. However, when these volumes become significant, NERL and our customers do not agree that it is efficient or fair for us to recover such costs from airlines through the en route charge. Rather, the guiding principle should be that the user pays, so that those benefiting from NERL's resources in planning and managing airspace to enable new airspace users should themselves pay for these activities. We request that the CAA works with the Department for Transport to set up charging schemes for these users as quickly as possible. This was a potential issue for RP3 and it is only becoming more prominent in the forthcoming NR23 regulatory period. Not having these arrangements in place could jeopardise the UK Government's objective of developing a national space industry.

2.2. Customer consultation

- 23 We welcome the CAA's support for our plan of customer engagement with initial engagement discussions having taken place in June 2021, with in-depth consultation planned in October and November 2021. This included attendance from all levels of the CAA organisation at the kick-off meeting in June 2021, which was appreciated by NERL and airlines.
- 24 In relation to the options the CAA has put forward, we will provide support to ensure customers have the resources they need to be effective in the consultation process. We believe that we have a plan in place that allows us to provide relevant information to customers in a timely fashion and enable them to discuss with us our proposals for NR23.
- 25 However, we are sceptical about the value that could be offered by utilising a "user champion". It is not clear what the champion could do that the CAA could not unless the CAA does not have the resources to provide this support to users. The CAA has significant knowledge and experience of aviation as well as air traffic control. It is guided by its duties and is well networked with the relevant stakeholders compared to an independent consultant. The champion is also likely to diminish the opportunity for airspace users to engage directly with NERL, which is one of the main reasons that the CAA intends to maintain an observer status during this process, intervening only for clarifications.

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- 26 We have appointed our own co-chair to support the work of the customer engagement process, along with the airlines' co-chair. We will ask our co-chair to work with the airlines' co-chair to write a report to the CAA that highlights the areas of agreement and disagreement through the customer consultation process.
- 27 We understand that the CAA will be guided by its underlying duties in whether it takes this feedback on board or not in its proposals for NERL for NR23. Nonetheless, given the resource commitment of NERL and airlines to the customer consultation process, we would welcome an explanation from the CAA if its proposals do not reflect the views of NERL and airlines, especially where the two parties are in agreement. We request that the CAA acknowledges areas where airline and NERL views are aligned and why it has not taken them on board in its initial proposals document for NR23. Within its RP3 Performance Plan, we did not understand why the CAA did not reflect areas of agreement, such as focusing the 3Di metric on elements within NERL's control and setting up a separate funding and charging model for unmanned traffic that was outside of the en route charge.

3. Reconciliation review

- 28 We welcome the CAA's delay of its reconciliation review of NERL's costs from 2020 to 2022 until February 2022. Similar to the CAA's scrutiny of NERL's NR23 business plan, many of the same NERL staff will have to provide information to and answer questions from the CAA's consultants on the reconciliation review who are developing the NERL NR23 business plan. Less time spent with the CAA's consultants while we develop our NR23 business plan will lead to a higher quality plan that better reflects airline feedback.
- 29 We agree with the CAA's focus on UKATS operational expenditure for this exercise. This is due to its materiality and the scrutiny already in place for other building blocks such as capital expenditure and the Oceanic business. We believe it is appropriate to suspend incentive arrangements for the rest of RP3 because NERL's performance outcomes are likely to be driven by traffic variations that remain highly uncertain. We continue to welcome the CAA's approach of judging NERL's actions based on the information available at the time instead of the benefit of hindsight. We support the approach of a true-up in 2023 for 2022 if there is significant variation between forecast and outturn efficient costs.
- 30 However, pension costs should not be given the same focus as operational expenditure in the CAA's retrospective reconciliation. These costs are far more influenced by legislative protections and changes in market conditions that the CAA and customers are well aware of, than the changes in staffing levels that the CAA has highlighted. Further, we believe it is in the interests of customers, in terms of future costs, for stakeholders to have confidence in the CAA's Regulatory Policy Statement on pensions, that was only finalised six months ago after being worked on for over three years. Introducing uncertainty about the CAA's treatment of pension costs now for the RP3 period of 2020-2022 would be counterproductive.
- 31 In the context of the calculation of the cost of debt, we consider that unless there is clear evidence that NERL's recent debt issuance was inefficient given market benchmarks (for example, iBoxx indices), the actual costs incurred should form the basis of the cost of debt allowance.
- 32 While the CAA has developed its thinking on the reconciliation review since its March update, its covering of the issues in its update falls short of the content that would have been expected from the working paper that had previously been promised. While this may partly reflect the delay to this cost reconciliation exercise at our request, we hope that the CAA will be able to go further in its update of policy principles for the recovery of revenue over the 2020 to 2022 period, which is due in the autumn. These arrangements will determine whether the NR23 regulatory period is set up for success or not. Our investors will need clarity about the CAA's intentions for the recovery of revenue alongside a licence modification to prevent the automatic application of the traffic risk sharing mechanism in order to maintain their confidence in the business.