

10 June 2021

Dear Stakeholder

NERL: consultation on the programmes and projects to be assessed under the capex engagement incentive

This letter requests stakeholder feedback on the operation of the regulatory incentives on NERL in relation to the quality of its engagement on its capex programme. Please respond no later than 9 July 2021.

Introduction

In its review of our price control decision for NERL for RP3, the Competition and Markets Authority (“CMA”) found that NERL should be subject to a financial incentive on the quality of its engagement with users and other stakeholders over its capital expenditure (“capex”).

As the consequential changes to NERL’s economic licence came into effect from the beginning of 2021, the incentive applies only to NERL’s engagement on capex in 2021 and 2022. We have already published guidance on how we expect this incentive to work.¹

In summary the incentive uses scoring by an Independent Reviewer (“IR”). We have appointed Egis as the IR of NERL’s capex. The IR will score NERL’s performance against the assessment criteria set out by the CMA and described in the guidance. It will score each of a selected list of programmes and/or projects in NERL’s total capital programme for 2021 and 2022. In assessing NERL’s engagement on these projects and programmes, the IR will only look at NERL’s engagement with users during 2021 and 2022. For programmes and projects where NERL started engagement before 2021, the IR will not assess how well NERL engaged on them before the start of 2021.

The incentive arrangements are a “downside only” incentive that would lead to NERL facing a penalty if its overall score is below 3 (out of 5). The maximum penalty will be based on NERL’s return on equity 3.87% on its total capex in 2021 and 2022. For illustration, if NERL’s actual spending were to equal its forecast in its capex baseline, we calculate this amount to be £6.36 million. The maximum penalty will apply if the overall score is 1.5 or lower. In calculating any penalty, we will take account of the IR’s scores and representations from stakeholders (including NERL). We will make the final decision on the overall score. We expect that we will use the IR’s overall score and will only depart from it for good reasons which we will clearly identify.

The maximum penalty will be based on NERL’s return on equity on its total capex in 2021 and 2022. Any penalty will be implemented by either an adjustment to NERL’s regulatory asset base or a revenue adjustment at the next price control period (2023-2027).

¹ See “Economic regulation of NATS (En Route) plc: Decision on licence modifications and guidance, CAP2011 at Appendix E. www.caa.co.uk/CAP2011

Assessment criteria to be used by the IR

The guidance sets out the assessment criteria the IR will use to score NERL's engagement. These are:

- timeliness;
- user-focus;
- proportionality;
- optioneering;
- responsiveness to user comments; and
- corrective or mitigating action.

More detail on these assessment criteria is set out in the guidance.

Scoring

The IR will score NERL's engagement on each of the chosen programmes and projects using a scale of 1(weak) to 5 (excellent). The IR will calculate an overall capex engagement score, by:

- first calculating an average score for each programme or project by taking the simple average across the scores for each performance criterion; and
- then calculating an overall score as the weighted average of programme and project scores, where the weights will be each programme or project's capex value as a proportion of NERL's total capex of the programmes and projects subject to scrutiny under this incentive.

The approach we are proposing to adopt is for the IR to make an initial score of NERL's engagement based on the evidence in its interim Service and Investment Plan for 2021 (iSIP21) due by 31 July 2021. The IR will update its scores when NERL publishes SIP22 on 31 January 2022, with a final score when NERL publishes iSIP22 on 31 July 2022. Only the final score will be used for the calculation of any penalty payments.

This approach will enable us to see how NERL's engagement has progressed through the period, while also enabling the final score to be used in setting the NR23 price control. It also has the benefit of enabling us to identify any improvements to our approach than can be built into any refresh of the engagement incentive and/or associated guidance that we consider appropriate for the NR23 control itself.

The guidance contemplates that we consult on the assessment criteria (see paragraph 38 of the guidance). However, as we consulted on the criteria in developing the guidance in late 2020, we consider that these criteria should remain as set out in the guidance unless stakeholders identify very material issues that should be addressed urgently. We welcome stakeholders' views on this, as well as our approach to the timing of the assessment by the IR.

Request for stakeholder views on the programmes and/or projects to be scored

The guidance also requires us to consult with stakeholders on the "projects and/or programmes" that the IR will score. NERL's overall capex baseline programme for 2020-22 is in its customer LTIP quarterly dashboard and programme summary on NERL's customer website.

Having considered the capex baseline prepared by NERL, we set out below three potential options that we could use for the IR's scoring together with weightings based on the

comparative capital spending (in brackets). Advantages and disadvantages of the options follow.

Option 1 – All eight programmes in NERL’s baseline programme

- DP (En-Route) – (51%)
- Airspace – (11%)
- Sustainment and surveillance – (17%)
- Facilities management (FM) – (8%)
- Information systems (IS) – (6%)
- Oceanic – (2%)
- iTEC collaboration – (5%)
- Simulation transformation and sustainment – (<1%)

Option 2 – The five largest programmes by forecast spend plus the AD6 Essex Radar airspace change project:

- DP (En Route) – (55%)
- Airspace – (10%)
- Sustainment and surveillance – (18%)
- Facilities management (FM) – (9%)
- Information systems (IS) – (7%)
- SAIP AD6 Essex radar airspace change - (c1%)

Option 3 – The DP (En Route) and airspace programmes only:

- DP (En-Route) – (83%)
- Airspace – (17%)

Advantages and disadvantages of each option

There is no “obvious” or “perfect” subset of programmes and projects that should be used. The larger the number of programmes and projects included in the assessment, the larger the proportion of NERL’s total programme that will be covered and, so, engagement incentivised. However, the converse of this is that the larger the number of programmes and projects included the lower the weighting given to each individual programme or project will be. So, if there are specific programmes or projects that users are particularly interested in and value engagement on, a smaller list of programmes and projects would increase the weighting (and incentive) for these specific programmes and projects.

The table below sets out the pros and cons of each option.

	Pros	Cons
Option 1	Covers all NERL’s programmes, incentivising engagement on all of NERL’s capex.	<p>Weightings for specific programmes are lower than if fewer programmes included.</p> <p>May not focus attention more closely on the areas that customers most value.</p> <p>May lead to a less proportionate approach to the IR’s work on smaller projects.</p> <p>Does not identify any specific projects which users may particularly value for</p>

		separate consideration by the IR.
Option 2	<p>Covers most of NERL's total engagement (93%), so would focus the IR's assessment on areas where NERL's proposed spending is most significant.</p> <p>Includes specific mention of AD6 airspace change project which affects aircraft using Stansted and Luton airports (c45m passengers in 2019) and ranked 1st for capacity improvements and 2nd for safety improvements in NERL's ranking of airspace projects in its October 2020 capex consultation.</p>	<p>Excludes the smallest programmes in overall programme.</p> <p>Weightings for specific programmes (and therefore scoring for the incentive) is not much higher than in Option 1.</p> <p>May include some "business as usual" spending on activities that are more of a "facilities management" nature that may be of less importance to stakeholders.</p> <p>May exclude some lower value projects that may be of more importance to stakeholders.</p>
Option 3	<p>We consider that this option would focus attention on the most significant spending areas proposed by NERL by giving higher weightings for transformational programmes, DP (En Route) and airspace which would increase the resilience of NERL's systems and lead to capacity and environmental benefits.</p>	<p>Only covers 62% of NERL's total programme.</p> <p>Excludes some programmes that directly affect the resilience of NERL's service.</p>

Next steps

We welcome stakeholders' views on the issues set out in this letter and, in particular, on:

- the timescale over which the IR's assessment should run, including whether the IR's final assessment should be made on the iSIP2022; and
- the projects and programmes that should be used for the IR's assessment, including the options set out above.

Please can you send to economicregulation@caa.co.uk your views on what programmes and/or projects should be included for assessment by 9 July 2021. If you have any questions please contact rod.gander@caa.co.uk.

Yours sincerely



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