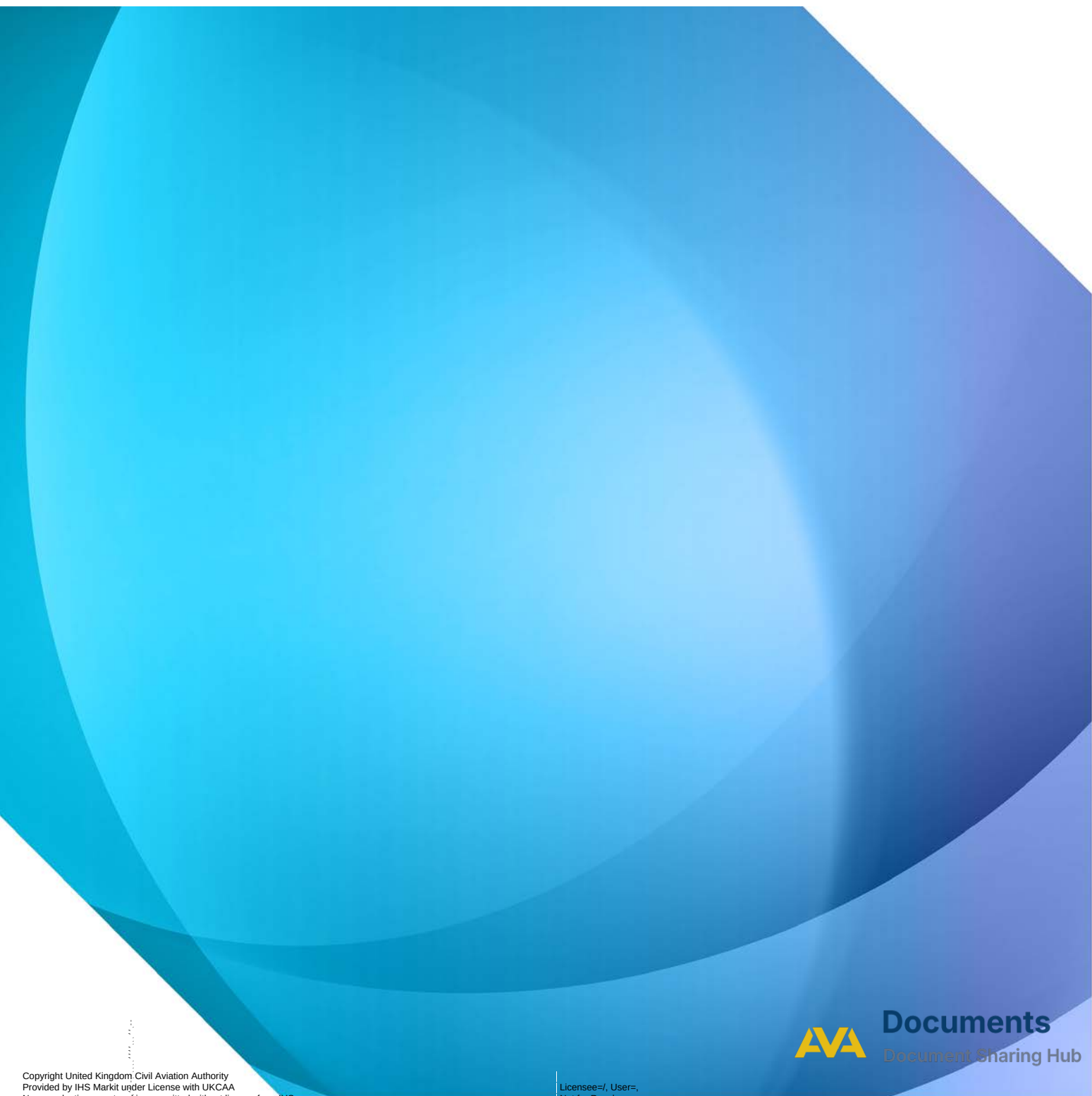


Guidance for NERL in preparing its business plan for Reference Period 3: consultation document

CAP 1593



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About this document

This consultation document seeks views from all interested parties on the CAA's approach to business plan guidance to NERL for the period from 2020 to 2024. Following consideration of feedback on this document and engagement with stakeholders, we intend to publish final business plan guidance for NERL in January 2018.

The NERL business plan will inform the CAA review for Reference Period 3 UK performance plan and targets, including the NERL price control, for the period 2020 to 2024.

Views invited

We welcome views on all the issues raised in this document. Responses should be sent to economicregulation@caa.co.uk no later than 5pm on 10 November 2017. We cannot commit to take into account any representations received after this date.

We are keen to engage with anyone interested in the future regulation of NERL. If you would like to discuss the issues raised in this document, please contact Bronwyn Fraser on bronwyn.fraser@caa.co.uk or on 020 7453 6291.

Representations received in response to this document will be made available on our website unless they are explicitly marked as "confidential". Where responses are sent by email, any material considered confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to disclosure of information under Schedule 9 of the Transport Act 2000 and the Freedom of Information Act 2000, and it may be necessary for us to disclose information received consistent with these requirements.

Introduction and summary

1. NATS (En Route) Plc (NERL) provides en route (both domestic and Oceanic) and certain approach air traffic services in the UK. As a monopoly, it is subject to economic regulation under the European Union's (EU) Single European Sky (SES) Performance Scheme for Air Navigation Services, which provides for the setting of targets and incentives to drive performance, and the Transport Act 2000 which sets a broader regulatory framework.
2. In April 2017 we published a discussion document setting out our proposed strategic outcomes for the regulation of NERL for the next reference period, Reference Period 3 (RP3), which runs from January 2020 to December 2024.
3. We are now consulting on guidance to NERL for the preparation of its business plan for RP3. Following this consultation we will update and confirm our guidance to NERL in January 2018, ahead of NERL producing its initial business plan (IBP) for customer consultation by March 2018.
4. In autumn 2018, following customer consultation, NERL will provide a revised business plan (RBP) that we will use to inform the development of the performance plan and targets for NERL in RP3.

Purpose and approach

5. This document:
 - Provides feedback on our April 2017 discussion document '[Strategic Outcomes for the Economic Regulation of NERL 2020-24](#)' (CAP 1511);
 - Consults on our approach to RP3 business plan guidance for NERL; and
 - Consults on our guidance on customer consultation.
6. To align with the timetable set down by the European Commission (EC), NERL must prepare a business plan in early 2018 that relates to the period 2020-2024. Some of the key future requirements for NERL during RP3 are likely to evolve over time. Therefore, it is important that our approach has a degree of flexibility that can accommodate such changes so they can be funded and appropriately incentivised, while respecting the timetable for developing the proposals for RP3 and allowing time for consultation on NERL's plans.
7. NERL should own and justify the key assumptions underlying its business plan and only where there are good reasons for detailed regulatory guidance on assumptions should we make exceptions to this approach. This is a different

approach to Reference Period 2 (RP2 – 2015-2019), where we provided a number of detailed assumptions and targets as guidance to NERL in preparing its business plan.

8. It is important that NERL rises to the challenge of producing a well evidenced business plan that wins both our confidence and that of other stakeholders. In this context an unnecessarily interventionist approach by the CAA at an early stage may distract NERL's attention and focus from establishing a persuasive and well evidenced vision for the services it provides to its customers, passengers and other stakeholders.
9. Nonetheless, certain higher level guidance may be appropriate (in particular relating to scope and issues to be covered) and it is important that NERL understands our broad expectations for its business plan and our expectations as to the sort of evidence the business plan should contain. First and foremost, NERL's plans need to deliver safe and resilient services for users. We are also proposing that NERL adopts a **two track approach** to the development of its business plan. This reflects the significant developments in and requirements from air traffic management and airspace – among other considerations – in the RP3 period and beyond. Faced with the differing stages of development and the nature of the issues to be addressed, we expect NERL to develop:
 - A baseline business plan incorporating known and expected requirements – 'core' requirements; and
 - Supplemental information setting out incremental effects on costs, and performance generally, of less certain changes that are likely but less certain – 'wider' requirements.
10. Adopting this two track approach should allow NERL to progress with the development of its business plan, while providing an opportunity to take into account the impact of wider issues as they mature. We also provide high level guidance on outcomes and outputs, costs and financeability issues.

Feedback on strategic outcomes

11. CAP 1511 proposed the following strategic outcomes for the regulatory review of NERL's activities in RP3:
 - Effective accountability mechanisms – in particular in the context of better business planning and delivery, and providing for a leading role for NERL in respect of modernising the UK airspace architecture;
 - Efficient prices; and

- Service quality improvement – in particular in respect of resilience and a broader view on the environment to include the impact of noise.
12. Stakeholders generally supported the strategic outcomes set out in CAP 1511 for guiding the development of the regulatory framework for NERL. Nonetheless, stakeholders raised a number of specific issues of concern, including concerns regarding the governance of the capital programme given the decision to delay the London Airspace Management Programme (LAMP2) in RP2. Where appropriate these issues are highlighted in this document.
 13. Several stakeholders (including NERL) suggested that safety should also be a strategic outcome. While safety was not explicitly presented as a strategic outcome in CAP 1511, we said that all of NERL's activities should always be in the context of maintaining safety. To be clear, it is our expectation that NERL will develop its business plan taking full account of its own safety obligations, demonstrating how it is maintaining safety and where it plans to improve its safety performance.
 14. The Transport Act 2000 gives the CAA a primary duty to exercise its functions so as to maintain a high standard of safety in the provision of air traffic services; it also places a duty on NERL, as the licence holder, to provide a safe system for air traffic services. The EU SES regulations also emphasise the importance of safety.
 15. Bearing the above in mind, our view is that safety should not be a separate strategic outcome as it should be a pervasive feature of NERL's business plan and its central focus, where appropriate supported by carefully thought through indicators and metrics such that its safety performance is both robust and transparent. The CAA considers that NERL's pursuit of economic and service quality performance outcomes can never be at the expense of safety.
 16. We received eight responses to CAP 1511 from a range of different stakeholders. These responses are published in full on the CAA website. Comments in relation to safety have been addressed above. Other comments that relate to business plan guidance or customer consultation are dealt with in the following chapters of this document. A brief summary of responses is set out below (a fuller summary of responses to CAP 1511 is set out in Appendix C):
 - British Airways and Virgin Atlantic Airways highlighted the importance of delivering LAMP2 in RP3, and considering noise alongside new capacity and costs for airspace users;
 - Gatwick Airport Limited's (GAL) response raised a number of issues, including the need for engagement with airport operators as stakeholders and strategic leadership from Government on airspace design. Biggin Hill Airport Limited (BHAL) indicated it wanted to be included in the scope of the London Approach service;

- A resident overflown by aircraft using Heathrow Airport also highlighted noise as an issue, stating NERL should take into account the interests of affected communities;
- NERL's response sought to address a wide range of issues for RP3, highlighting the significance of airspace change while highlighting its desire for a performance plan that is safety and service led;
- The Prospect Air Traffic Control Officers' (ATCO) Branch's response indicated its hope that RP3 would remedy its concerns from RP2, including perceived CAA sensitivity to airline pressure to cut costs; and
- The response from the trustees of the NATS pension scheme stressed the importance of retaining an ongoing stable and predictable treatment of NERL's defined benefit pension scheme.

Outcomes and outputs

17. In CAP 1511 we noted that the quality of services (strategic outcome three) provided by NERL across all its activities was very important for airspace users, while also providing a safe and efficient service as an essential minimum requirement. We also stressed the importance of ensuring effective mechanisms to hold NERL to account for delivery (strategic outcome one). Minimising the impact of delay on airspace users and mitigating the impact of aviation on the environment are also important, both for those that benefit from air navigation services and those that are impacted by actions of Air Navigation Service Providers (ANSPs).
18. In developing its RP3 business plan, NERL will need to consult both with its customers as well as understanding the requirements of passengers and overflown communities. We expect that NERL's business plan will address:
 - The need for a safe service;
 - Delay performance for its key licensed activities establishing challenging targets for RP3, in the context of understanding traffic evolution, high quality data and customer requirements;
 - Flight efficient routeing and the noise impact of air navigation services – including understanding where improving flight efficiency performance improvements might lead to adverse noise impacts on communities and developing mitigation proposals;

- Technical and operational resilience – understanding and providing the appropriate level of systems resilience to achieve a high level of network performance even as it deploys new Air Traffic Management (ATM) technologies, and ensuring it has in place robust procedures and processes to identify and plan for future operating requirements. This should also reflect any changes that are necessary by way of learning from the CAA's recent investigation of NERL's performance at Stansted Airport following complaints made by Ryanair and Stansted Airport Limited; and
 - Developments in airspace use and architecture – for example, how NERL will continue to safely and efficiently manage existing airspace users as new classes of airspace users look to operate near and in the same airspace, and exploring NERL's role in the delivery of a modernised airspace architecture.
19. Core requirements which drive service quality in respect of capacity, resilience and the environment should be incentivised appropriately. NERL should set out proposals for incentives (both financial and non-financial) in its business plan.
20. NERL should clearly set out in its business plan how wider requirements could influence outcomes/outputs, costs and consider possible incentive mechanisms (including those relating to airspace change).

Costs

21. As discussed in CAP 1511, delivery of efficient prices (strategic outcome two) will include establishing efficient cost estimates, as well as governance processes and incentives to respond to changes in requirements during the reference period.
22. We expect that in developing its RP3 business plan, NERL will demonstrate that its proposed costs (both capital and operational) are efficient using appropriate benchmarking.
23. The significant change to the original capital expenditure (capex) programme early in RP2, where the focus switched from airspace change to replacement of legacy systems, highlights the key requirement for NERL to establish with customers transparent and effective consultation and governance mechanisms (in accordance with strategic outcome one) for the management of the capex programme. These mechanisms are not only in relation to developing a high quality, credible and cost efficient capital programme for the start of RP3, but that are able to respond to changes in the operating environment, user requirements and policy during the reference period. NERL should also consider how its capital programme should be managed and incentivised over multiple reference periods.

24. It is important that NERL's total costs are efficient, and that its business plan identifies the appropriate balance between capital and operating costs. This review also provides the opportunity to consider whether the costs and allowances for the Future Airspace Strategy (FAS)¹ Deployment Facilitation Fund (FFF) are reasonable and efficient.
25. The cost of NERL's pension obligations is a significant component of its cost base and a key issue identified by respondents to CAP 1511. In developing its business plan, NERL will need to provide:
- Compelling evidence that it has behaved and is continuing to behave in a manner consistent with a commercially minded company; and
 - That it has taken all steps available to it within its legal discretion to manage and mitigate the pension cost burden on airspace users.
26. We expect that pension deficit costs, as they relate to past service, will all be identified as core costs, whereas ongoing pension costs, because they relate to future service, may be shown as both core and wider costs.

Financeability

27. In delivering efficient prices, a key consideration for the CAA and NERL is that the resulting performance targets and service quality incentives do not make it unduly difficult for NERL to finance its licensed activities.
28. NERL should develop its own proposals with respect to the level of allowed profit through the Weighted Average Cost of Capital (WACC) and the Regulatory Asset Base (RAB). In doing so we would expect NERL to base its business plan on a well evidenced view of an efficient WACC.
29. We expect to publish an early and preliminary range for Heathrow Airport Limited's (HAL) WACC in December 2017. NERL should have regard to the information that is provided on market wide elements of the cost of capital in developing its proposals for its WACC.
30. NERL should also set out the other evidence that it regards as necessary and appropriate to demonstrate that its business plan is efficient and financeable, including the credit metrics that would allow it to continue to access debt finance on reasonable terms.
31. The level of regulatory depreciation is expected to fall during RP3 as the assets at privatisation are fully depreciated, and this may impact on revenues and cash

¹ The Future Airspace Strategy sets out a vision to modernise UK airspace and use technology to make it fit for the 21st century. See: <http://futureairspace.aero/>

flow. If this or other issues (such as pension deficit recovery costs) raise issues for financeability, NERL should explain how these matters can be best addressed efficiently, while continuing to deliver affordable services for its customers.

Customer consultation

32. NERL's customer consultation in previous regulatory reviews has focused on airspace users. Bearing in mind our expectation that NERL will have a significant role in the development of South East airspace change we consider that airspace users and airports should be consultees for its business plan.
33. We are also interested in stakeholders' views on whether NERL's RP3 consultation processes should be based on those adopted for RP2 with incremental changes to deliver improvements, or whether more fundamental changes and/or an alternative model may be appropriate.
34. Wider policy issues of resilience and noise have direct impacts on final consumers (i.e. passengers), and affected overflown communities. We expect NERL to carefully consider the way in which it engages to understand the views of these stakeholders.
35. To facilitate development of the RP2 performance plan we published several consultancy reports to help inform both stakeholders' and our views. We intend to conduct research to scrutinise NERL's RP3 business plan. In response to feedback on the RP2 process and CAP 1511, we are currently planning to commission some aspects of this work earlier in the process than was the case for RP2, to coincide with and inform the customer consultation process.
36. We are interested in stakeholders' views as to the proposed CAA consultancy studies as set out in Appendix D.

Our duties

37. In developing our proposed approach and policies in this document we have had full regard to our duties under the Transport Act 2000 and functions as a national supervisory authority under the SES Performance Scheme, both of which are summarised in Appendix A.

Proposed timetable and next steps

38. Our programme is, to a significant extent, driven by the need to align with the EU process to develop the regulatory framework and targets for the RP3 period. The current high level milestones are summarised below:

Milestone	Indicative dates
NERL customer consultation on its initial business plan	April – September 2018
EC adoption of revised regulations for RP3 and adoption of EU targets ²	June 2018
NERL submission of revised business plan	October 2018
CAA consultation on draft RP3 performance plan	January – March 2019
Department for Transport (DfT) adoption of RP3 performance plan and submission to the European Commission	June 2019
European Commission assessment of performance plans	July – November 2019

39. CAA consultancy studies will be scheduled throughout 2018 in response to key deliverables - see Chapter 5 and Appendix D for further details.

Structure of this document

40. The structure of this document is as follows:
- **Chapter 1** outlines our proposed high level approach to RP3 business plan guidance for NERL
 - **Chapter 2** sets out draft guidance to NERL on outcomes and outputs
 - **Chapter 3** provides draft guidance to NERL on the efficient costs necessary to deliver the outcomes and outputs
 - **Chapter 4** provides draft guidance to NERL on demonstrating financeability
 - **Chapter 5** sets out our proposed approach to customer consultation
 - **Appendix A** sets out our duties under the Transport Act 2000 and role as national supervisory authority under the EU SES Performance Scheme

² The current SES Performance regulation requires EU targets to be adopted no later than 12 months before the start of the Reference Period – i.e. December 2018, however the EC has indicated that it intends to adopt the EU targets by June 2018.

- **Appendix B** provides a list of all the consultation questions
- **Appendix C** summarises the responses to CAP 1511
- **Appendix D** sets out the proposed CAA consultancy studies for RP3 in terms of objectives, scope and deliverables
- **Appendix E** provides an overview of the building block approach

Chapter 1

Approach to RP3 Business Plan development

- 1.1 This chapter sets out our proposed approach to RP3 business plan guidance to NERL. It sets out a framework for how we expect NERL to address requirements that are not expected to be well defined before NERL submits its business plan – a two-track approach – and provides an update on EU context and milestones.

CAA approach to guidance

- 1.2 Our key principle is that NERL should own and justify the key assumptions underlying its business plan and only where there is a compelling reason for detailed regulatory guidance should an exception be made to this approach. This is different to the approach to RP2, where we provided a level of detail in published correspondence between CAA and NERL as part of the RP2 business plan development process.
- 1.3 NERL should be able to rise to the challenge of producing a well evidenced business plan that will gain both our confidence and that of other stakeholders. In this context an unnecessarily interventionist approach by the CAA at an early stage may distract NERL's attention and focus from establishing a persuasive and well evidenced vision for its business plan and the services it provides to its customers, passengers and other stakeholders.
- 1.4 In considering the form and scope of their business plan we expect NERL to take account of requirements under both the current regulatory framework, and any developments that emerge in respect of the SES RP3 framework, as well as meeting stakeholders' expectations. In doing so, NERL should set out its justifications and rationale for the assumptions and parameters it proposes, given its overall vision for RP3.
- 1.5 We expect NERL's business plan to cover the regulated activities under its Air Traffic Services Licence, in particular the UK En Route and London Approach services under scope of the EU and domestic regime; as well as the Oceanic service, which is subject only to the domestic regime. In particular, in relation to the London Approach service, we expect NERL to consider the allocation of costs between London Approach and En Route, the airports within scope and level of granularity it provides in terms of service quality measures.
- 1.6 Where appropriate and in line with our key principle above, more detailed guidance is proposed in the remainder of this document.

- 1.7 Given the future impact of Brexit and that the SES regulatory framework for RP3 is subject to review and change, it is not yet known what requirements might be in respect of development of a UK-Ireland Functional Airspace Block (FAB) performance plan for RP3. Where this turns out to be the case, and where appropriate, references to the UK performance plan should be construed as the UK-IE performance plan and that CAA will work with the Irish Aviation Authority's Safety Regulation Department accordingly.
- 1.8 In terms of the broader implications of Brexit on the development of the RP3 performance plan, and therefore guidance to NERL in developing their business plan, our view remains that there will be similar substantive regulatory requirements. If the institutional arrangements change, whether the UK is under the European or domestic legislative framework, we expect to produce a price cap and service quality targets that go towards achieving the strategic objectives above and CAP 1511, irrespective of the regulatory framework in place.

Two track approach

- 1.9 We are conscious that there are certain issues that may require funding from NERL's RP3 price control revenue, particularly in respect of the strategic outcome on effective accountability mechanisms, that could be important for NERL, its customers and consumers more generally, but that are at an early stage of development. These include airspace modernisation and certain new technologies.
- 1.10 Faced with these challenges, the CAA proposes NERL adopt a two track approach to developing its business plan. This approach should include the following two elements:
- A baseline business plan incorporating known and expected requirements – “core” (e.g. delay targets); and
 - Supplemental information setting out the incremental effects on costs and performance of less certain requirements and possible future developments – “wider” (e.g. airspace architecture modernisation).
- 1.11 This approach should allow NERL to make progress with the development of a business plan that is fully costed, safety focused, well justified and high quality. It allows NERL to set out how it will deliver the activities characterised as “core”, while providing an opportunity to account for possible future developments of the “wider” considerations. These may include:
- the potential future role of NERL in modernisation of airspace architecture; considering what role NERL might have in the development of any airspace masterplan and how this might impact on their operations in RP3 and beyond;

- potential cyber security obligations in accordance with developing Government policy – taking account of obligations that might arise from the EU Network and Information (NIS) Directive;
- responding to the introduction of new and potentially disruptive technologies (for example, drones) in a way that leads to positive outcomes for consumers - considering the possibility that the introduction of new technologies allow for the development of and significant changes to ways of operating; and
- responding to developments in relation to Brexit.

1.12 We expect NERL to:

- clearly identify in its business plan both the “core” and “wider” considerations required to meet the established strategic outcomes;
- set out where there are a range of options to deliver capacity, resilience, environmental and safety performance. In doing so, NERL should clearly articulate its particular requirements and costs as being either “core” or “wider”, along with its rationale for why they consider them to be so; and
- identify its preferred option.

1.13 Chapters 2 to 4 of this document provide, for consultation, draft guidance to NERL in respect of outcomes, costs, and financeability, with indicative views of “core” and “wider” considerations.

Other matters

1.14 We expect NERL to take care to clearly justify the assumptions it uses in its business plan and make forecasts of the efficient costs necessary to deliver outputs and outcomes. NERL should take account of requirements under both the current regulatory framework, and any developments as they emerge in respect of the SES RP3 framework. It should use a building block approach (as summarised in Appendix E) to establish levels of required revenue, and present costs information as clearly, transparently, and on an as consistent basis as possible to support effective stakeholder engagement. In particular, in relation to:

- Military and other activities included in the single till;
- Treatments of total and chargeable service units;
- Use of calendar years and choice of inflation indexation; and
- Use of a consistent price base.

1.15 NERL should use the traffic (including service units) and economic forecasts it thinks most appropriate, justifying them accordingly, mindful of existing regulatory requirements.

- 1.16 It should propose and justify the start point it uses for cost efficiency calculations, ensuring data are presented in a way that enables ready comparison and analysis of performance with previous reference periods. NERL should be clear on its treatment of true-ups between reference periods in relation to costs, but should also provide information on the impact of such true-ups will have on charges.

EU context and timetable update

- 1.17 In March 2017 the EC set out certain options for the revision of the two SES performance regulations – the performance regulation and the charging regulation.³ Following a period of written consultation with Member States and industry stakeholders, the options and consultation responses formed the basis for an impact assessment study.
- 1.18 The preliminary results of the study are expected in autumn/winter 2017 shortly followed by draft legislative proposals. The EC timeline also includes a period of open consultation on the proposals before their adoption. The text should be available on the EC's Better Regulation⁴ portal in the first half of 2018.
- 1.19 The EC also initiated a specific study on incentive schemes, the results of which are expected to be published in October 2017.
- 1.20 It is understood that once the process for adopting the new performance and charging regulations is sufficiently mature, parallel work will be carried out on proposals for EU-wide performance targets. The latest EC timeline indicates a parallel adoption of the new regulations and the decision on targets in mid-2018.
- 1.21 In its preparation for RP3, the EC is supported by the Performance Review Body (PRB) which is an advisory body of experts. The PRB is expected to drive the proposals for EU-wide targets and eventually carry out the assessment of RP3 performance plans once they are adopted by Member States.
- 1.22 Subject to an EC decision, there may not be a requirement to produce a FAB plan with Ireland for RP3, as was the case for RP2.
- 1.23 We continue to provide input to the development of the revised regulations to ensure, as far as practicable, that they are consistent with the UK's strategic outcomes for the future economic regulation of NERL.

³ COMMISSION IMPLEMENTING REGULATION (EU) No 390/2013 of 3 May 2013 laying down a performance scheme for air navigation services and network functions and COMMISSION IMPLEMENTING REGULATION (EU) No 391/2013 of 3 May 2013 laying down a common charging scheme for air navigation services.

⁴ https://ec.europa.eu/info/law/better-regulation/have-your-say_en

Consultation questions

1. Do stakeholders consider that a two track approach to NERL's business plan is reasonable?