

Economic regulation of NATS (En Route) Plc: consultation on licence modifications to implement exceptional measures

CAP 2245

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About this document

We are consulting on making changes to the price controls for NATS (En Route) Plc's (NERL's) regulated activities under its air traffic services licence for the year 2022, following on from the policy set in our December 2020 consultation (CAP1994), March 2021 update (CAP2119) and June 2021 update (CAP2160).

This document constitutes notice under section 11A(1) of the Transport Act 2000 of the proposed modifications that the CAA intends to make to NERL's licence. We set out our proposal to disapply the automatic calculation of the traffic risk sharing mechanism used to set the maximum Eurocontrol and London Approach service charges in 2022. These charges would otherwise increase sharply to recover allowed revenues from 2020 as a result of the reduction in traffic levels due to covid-19 pandemic. The main purpose of these modifications is to disapply this automatic calculation of the traffic risk sharing mechanism for 2022. Instead, allowed revenues will be recovered over a longer period of time to smooth the impact on charges to airspace users. The period of recovery will be determined through the next price control review ("NR23").

We are also proposing modifications for exceptional measures to remove service quality incentives for 2020 that have been unduly affected by the impact of covid-19 on traffic levels, and further technical modifications necessary to implement the CMA's determination for the period 2020-2022.

Next steps

We welcome representations on the licence modifications and policy set out in this document to economicregulation@caa.co.uk by no later than 29 October 2021.

We expect to publish the representations on our website for other interested parties to read after the period for written representations expires. Any material that is regarded as confidential should be clearly marked as such and provided in a separate appendix. Please note that we have powers and duties with respect to information under Section 102 of the Act and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Anna Muoghalu (anna.muoghalu@caa.co.uk).

Summary and introduction

Introduction

1. NATS (En Route) Plc (NERL) is the monopoly provider of en route and certain approach air traffic services (ATS) in the UK and is subject to economic regulation of its services under the Transport Act 2000 (the Act) and licence conditions. NERL's price controls set the maximum charges that it can recover from airspace users for its Eurocontrol en route, London Approach and Oceanic en route services.
2. The current price controls (following the CMA's determination) started on 1 January 2020 and will end on 31 December 2022. During the period when the CMA was considering the reference, covid-19 emerged as a global pandemic, with the resulting severe and unprecedented downturn across the aviation sector. The CMA 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.
3. We set out in the June 2021 update¹ that we will complete a reconciliation of costs and revenues for the period 2020-2022 to take account of the impact of covid-19 on traffic levels as part of the next price review ("NR23"). However, as the current price controls include automatic adjustments that would significantly increase the maximum allowed charges in 2022, to meet our statutory duties we consider that we need to make the following modifications to the NERL licence ahead of the NR23 decisions to take account of these exceptional circumstances:
 - licence modifications to disapply the automatic traffic risk-sharing mechanism for 2022 charges; and
 - licence modifications to disapply the service quality incentive payments for 2022 charges.
4. The modifications to disapply traffic risk-sharing ("TRS") are considered an exceptional measure taken as a result of the impacts of covid-19 on traffic levels. These modifications relate to the automatic application of TRS to recover 2020 allowed revenues in 2022 charges. We expect to take a consistent approach at the NR23 price control review when considering the automatic recovery of 2021 and 2022 allowed revenues (in 2023 and 2024 charges respectively). These measures are relevant to the current exceptional circumstances and are not

¹ www.caa.co.uk/cap2160

intended to be the starting point for considering the appropriate TRS mechanism for the NR23 period.

5. In chapter 1 we provide details of the proposed licence modifications and an update on our policy on the recovery of 2020-2022 allowed revenues under the TRS. We expect these revenues to be recovered over one or two price control periods to smooth the impact on airspace user charges, while continuing to take account of the financial impact on NERL. During the NR23 price review, we will carry out analysis on the efficient cost baseline for 2020-2022 and consider the timing of the recovery of TRS revenues, bearing in mind both the affordability of charges and financeability of the regulated company. We will set out our decisions on recovery of these TRS revenues in the NR23 initial and final proposals documents in 2022.
6. In chapter 2 we provide details of the proposed licence modifications to disapply service quality incentives related to 2022 charges. As a result of the significantly lower than expected traffic levels in 2020, capacity delays were significantly below target levels and automatic application of these incentives would provide bonus payments from airspace users to NERL to be recovered through 2022 charges. As these payments are the result of the current exceptional circumstances outside NERL's control, we propose to disapply these 2020 payments for 2022 charges. We would expect to take a consistent approach to any 2021 payments and, potentially, 2022 payments depending on the extent of traffic recovery.
7. In chapter 3 we set out details of a proposed licence modification that relates to the recovery of allowed revenues in 2020 under the CMA determination. The chapter also outlines the proposed annual review protocol for the 3Di performance measure.
8. The proposed modified licence conditions are included in Appendix A to this consultation.
9. The statutory framework that governs this licence modification process is the new regime in the Transport Act 2000 as amended by the Air Traffic Management and Unmanned Aircraft Act 2021. This means that we can modify licence conditions without needing NERL's consent, subject to appropriate stakeholder consultation. This consultation is pursuant to these statutory requirements to consult on licence modifications before implementation. This document constitutes notice under section 11A(1) of the Act of the proposed modifications that the CAA intends to make to NERL's licence.

Views invited and next steps

10. We invite representations on the suggested modifications to economicregulation@caa.co.uk by 29 October 2021.

11. We expect to publish the representations on our website for other interested parties to read after the period for written representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex.
12. We will consider representations received before deciding whether to proceed with the proposed modifications to NERL's licence.

Chapter 1

Traffic risk-sharing mechanism

Introduction

- 1.1 In the December 2020 consultation² and March 2021 update³ we said we would need to carry out a reconciliation of the TRS arrangements for 2020 to 2022 and integrate the recovery of an appropriate level of revenue in our proposals for the next price control.
- 1.2 Respondents, including NERL, supported our intention to suspend the automatic application of the TRS mechanism in 2022 to avoid a steep increase in charges which could be unaffordable at a time when traffic was still relatively low due to the impact of covid-19. However, there were different views on the extent to which some, or all, of the shortfall in revenues should be met by the amended TRS arrangements or a combination of TRS, contributions from Government and contributions from shareholders.
- 1.3 In the March 2021 update we confirmed that, consistent with our statutory duties, we were seeking to develop an approach which delivers both affordable charges and supports NERL's financeability and efficient operation. We confirmed that we would carry out a reconciliation of costs and revenues for 2020 to 2022 and allow the recovery of revenue shortfall over a longer period than the automatic current two-year time lag. We also did not rule out setting price control arrangements on the basis that NERL's shareholders may need to provide additional support to the regulated business in response to the unprecedented and exceptional circumstances.
- 1.4 In the June 2021 update we confirmed our plans for the current licence modification proposal and said that as well as consulting on modifications to NERL's licence, we would address the policy principles that will guide our approach to the recovery of revenue shortfall from the 2020 to 2022 reconciliation review. We would then set out our approach to the recovery of the TRS revenue shortfall as part of the NR23 process.

Update on policy principles regarding recovery of 2020-2022 TRS revenue shortfall

- 1.5 We do not make any decisions at this stage on recovery of this revenue shortfall, as we will need to consider affordability of charges and financeability in the round

² www.caa.co.uk/cap1994

³ www.caa.co.uk/cap2119

as part of the NR23 review. However, we recognise the value in providing NERL and airspace users with further clarity at this stage over the main principles guiding our approach. These principles are set out below and are consistent with the direction of travel in our March 2021 and June 2021 updates.

Assessment of efficient cost baseline for reconciliation

- 1.6 We will reconcile costs and revenues for 2020, 2021 and 2022 on the basis of estimates of efficient costs. This efficient cost baseline may be lower than actual costs if we find evidence of inefficiency during our review, or if there are other reasons to adjust costs, such as to account for the furlough scheme. Our review will take account of information available to NERL at the time and will not rely on the benefit of hindsight.
- 1.7 The final calculation of the TRS recovery amount will be confirmed as part of the reconciliation exercise and will be based on this updated efficient cost baseline for 2020 to 2022. As indicated in the March 2021 update, to the extent practicable and consistent with supporting NERL's financeability, we intend to allow NERL to recover the full TRS revenue shortfall amount against this revised baseline. We consider that this is important for regulatory certainty, as NERL's licence included an explicit TRS mechanism.

Recovery period

- 1.8 In our March 2021 update we noted that we will consider the arrangements adopted for EU member states by the European Commission as an important benchmark for our approach. This referred specifically to the intention of spreading revenue recovery over a default five-year period with the possibility of extending it up to a total of seven years.
- 1.9 We consider that a five-year recovery period remains a valid starting point. However, where this is not appropriate, due to concerns around profiling and affordability of charges, we consider that it would be appropriate to extend the recovery period to the subsequent price review period, consistent with our statutory duties.
- 1.10 To the extent it is reasonable, we would allow NERL to recover the TRS revenue shortfall over NR23, subject to an assessment that charges are at affordable levels and we have appropriately considered financeability.⁴ Any outstanding amounts following the initial five-year period (NR23) would then be carried over and we would expect these to be recovered through revenues in the next price review period (NR28).

⁴ We provide further details in our March 2021 update ([CAP2119](#)), para 1.33, on what we mean by affordable charges, which mean that charges could increase in real terms, and we will carry out further work on what affordable charges should mean in practice as part of the NR23 price control review.

- 1.11 Under the EU approach, the revenue recovery will be spread equally over the five to seven-year period. We would not necessarily plan to limit this recovery to seven years in total from the commencement of NR23 (in line with the EU approach), partly because this would not allow ease of alignment with NERL's five-year price control periods, although we would not want recovery to take longer than two price control periods. However, as part of the NR23 review, we will consider the most appropriate option to profile the recovery of revenue, including potentially to align or bring it closer to the EU benchmark of five or seven years, taking into account our assessment of affordability and financeability.

Treatment of the RAB and financing costs

- 1.12 We recognise that NERL is currently accounting for the expected recovery of these TRS revenues in its regulated asset base (RAB) through a debtor in the movements in working capital.⁵ We consider this consistent with the rules that are in place for calculating NERL's RAB and we are not proposing any changes to these aspects of the RAB rules. As revenue is recovered over NR23 and beyond, the amount remaining in the working capital and therefore RAB will unwind. As there is an explicit TRS in the licence, we consider that using the RAB in this way can be appropriate as a means to spread the recovery of revenues over time, while providing certainty in the recovery of these revenues.
- 1.13 Under the RP3 RAB rules, financing costs are calculated on variances in capex and pension costs and capitalised in the RAB. Consistent with this approach, we consider that it would be appropriate to provide an allowance for financing costs or time value of money for the TRS recovery.
- 1.14 The capitalised financing costs on capex and pension costs are currently calculated based on the allowed cost of capital. For the TRS revenue shortfall, we will want to assess whether this is appropriate or whether we should use an alternative approach to calculate financing or time value of money costs. For example, as these adjustments essentially shield NERL from risk it may be appropriate to consider a range of options from applying the full cost of capital to applying only the allowed cost of debt. We will consider the appropriate approach, taking account of relevant regulatory precedent, as part of the NR23 review. We would welcome views from stakeholders on the approach we should take.

Role of NERL's shareholders

- 1.15 As indicated in our March 2021 update, we cannot at this stage rule out setting price control arrangements on the basis that NERL's shareholders may need to

⁵ See NERL's 2020 Regulatory Accounts available [here](#), page 18.

provide additional support to the regulated business, particularly if there were significant pressure from slower recovery of traffic on affordability of charges and NERL's financeability. At this stage there remains significant uncertainty about the future path of recovery in aviation, although we note that there has been some encouraging signs in recent months such as steady recovery in traffic volumes and recent government announcements about easing travel restrictions.

- 1.16 In reaching our view, we would also take into account previous actions from NERL's shareholders, such as dividend restraint, and consider how we can use regulatory levers and mechanisms to manage affordability and financeability, including profiling of depreciation and charges.

Licence modifications for 2022 charges

- 1.17 As set out above, as an exceptional response to the covid-19 pandemic, the associated downturn in traffic and resulting difference between allowed and actual revenues under TRS, we propose to modify the licence conditions so that the TRS adjustment for 2022 charges is set to zero.
- 1.18 Under the current licence conditions, we estimate the TRS revenue shortfall from 2020 to be recovered in 2022 to be around £380 million, which would add around £42 per service unit and represent a near 130% increase on the previously determined unit costs based on a recent STATFOR traffic forecast.⁶
- 1.19 The proposed modifications are included in Appendix A.

⁶ Calculated using STATFOR's May 2021 base-case traffic forecast for the UK for 2022.

Chapter 2

Service quality incentives

Introduction

- 2.1 As part of the RP3 determination, service quality incentives were set for environmental (3Di) and capacity (delay) targets. In 2020, the delays recorded by NERL were significantly below its capacity service quality targets. Under the current licence conditions, NERL would earn bonus payments in its 2022 charges. NERL also met its 3Di environmental performance target though there were no bonus payments associated with this.
- 2.2 The targets for delays in 2020 onwards did not reflect the impact from a significant downturn in traffic in 2020 and into 2021. In its response to the March 2021 update NERL acknowledged that it would not be appropriate for NERL to seek to recover from users these bonuses given that the achievement of the targets was materially easier while traffic remains well below levels anticipated. NERL therefore supported disapplying these incentives for 2020 to 2022. NERL also considered that equally, it should not be subject to penalties if traffic returns much quicker than expected over this period.
- 2.3 In our June 2021 update we set out our intention to disapply the 2020 incentives. We agree that the targets set for RP3 are no longer appropriate given the change in circumstances since they were set. We also think that given continued uncertainty and the concentration of efforts on the next price controls starting 2023, it would not be appropriate to review the established targets used for incentive schemes in 2020.
- 2.4 We also said we would consider the same approach for 2021 if traffic levels remained substantially below the baseline. In the meantime, we said that we would continue to monitor NERL's performance against the targets set for RP3. We intend to continue our usual activities in monitoring NERL's actual performance and will seek further information from NERL where the targets are not met. We also said we will conclude on the year 2022 as the path of traffic recovery becomes clearer.

Licence modification for 2022 charges

- 2.5 The modifications in this consultation relate only to the adjustment for financial incentives from the year 2020, which under current licence conditions would otherwise be fully carried over into 2022 prices. Under the current licence conditions, NERL would be entitled to bonus payments for its C2 and C3 financial incentive targets, up to 0.3% of determined costs, or around £2 million.

- 2.6 Rather than removing the RP3 incentives from the terms of the licence, for the purpose of the 2022 charges, we propose to state that the relevant terms in condition 21 will be equal to zero. This highlights the extraordinary nature of this adjustment and NERL should continue to deliver a high-quality service.
- 2.7 We anticipate the same approach to apply to 2021 and, potentially, 2022 incentives, if traffic levels remain substantially below the baseline. This will be confirmed as part of the NR23 price review.
- 2.8 The proposed licence modifications are shown in Appendix A.

Chapter 3

Other licence modifications

Introduction

- 3.1 In addition to consulting on modifications in chapters 1 and 2, we also propose a modification to allow for the recovery of allowed revenues in 2020 under the CMA determination.
- 3.2 We also take this opportunity to consult on the annual review protocol for the 3Di performance measure.

CMA uplift (temporary unit rate adjustment)

- 3.3 In December 2020 we implemented the CMA's decision on price controls from 2020 to 2022 retrospectively from 1 January 2020. As part of the consultation, we noted that NERL's allowed charges to users for 2020 for UKATS, Oceanic and London Approach were set according to our RP3 decision, whereas the CMA's final report and determination allowed a higher level of revenues and user charges in 2020.
- 3.4 Although the process for adjusting revenues due to an application of a temporary unit rate is foreseen in the European framework (and features in the cost reporting tables), the term has not been previously included in the NERL licence. It is our intention to allow this adjustment in the year 2022 and we have included an additional term in the price control formulae in conditions 21, 21a and 22. The impact on Eurocontrol service charges in 2022 is around £4.6 million.
- 3.5 We set out the proposed modifications in Appendix A. The different terms used for UKATS and Oceanic prices reflects the different measures of traffic volume used for setting charges (per total service unit and per flight respectively).

3Di annual review protocol

- 3.6 The licence modifications that implemented the CMA decision did not include the annual review protocol for 3Di for RP3. The protocol is not embedded in the licence and does not require a licence modification. It is being included in this consultation for completeness and to facilitate our review of NERL's 2020 performance. The annual review protocol is provided in Appendix B.
- 3.7 We do not propose any changes to the annual review process compared to the process established for RP2. For NR23 we will consider possible adjustments, including expanding the data set used for the purpose of the annual review, if 3Di is retained as a service quality measure.

- 3.8 The significant impact of the covid-19 pandemic on traffic levels led us to reprioritise our work and so we have not yet carried out the annual review process for the years 2019 (last year of RP2) and 2020 (first year of RP3). We note that NERL's calculations show the 3Di scores for those years were within the targeted deadbands, meaning there were no associated bonuses or penalties. We plan to carry out and publish the results of our review of 2019 and 2020 scores in due course.
- 3.9 We would welcome any views respondents have on the approach set out above or the detail of the protocol set out in Appendix B.