

Reference to the CMA of NERL RP3 price controls: CAA response to NERL's Statement of Case

CAP 1870

[RP3 reference CAA document 004]

Civil Aviation Authority, 2019

Civil Aviation Authority
Aviation House
Beehive Ring Road
Crawley
West Sussex
RH6 0YR

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Enquiries regarding the content of this publication should be addressed to: matt.claydon@caa.co.uk

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Contents

Contents	3
Executive summary	5
Section 1: Background and context	14
Experience of RP2	15
Customer consultation	15
Application of our statutory duties	15
The redetermination process	15
Section 2: Traffic forecasts	16
The advantages of the STATFOR's traffic forecast	17
The assumptions used by NERL in making its forecasts	18
Updated traffic forecasts	19
Section 3: Airspace Change Organising Group (ACOG)	20
Part 1 - Overview of airspace modernisation and the role of ACOG	20
Part 2 – Response to NERL's SoC	22
Status and funding of ACOG	23
Delivery of the airspace change masterplan	24
Section 4: Service quality and environmental (3Di) targets	30
Level of challenge	31
Incentives and exemptions	33
EU reference values	36
Target compliance and the licence	38
Section 5: Operating costs and non-regulated revenue	39
Part 1 – NERL's SoC	40
Past efficiency improvements	42
Efficiencies already built into NERL's plan	43
EU-wide cost efficiency target	44
Historical outperformance	44
Expected efficiencies in 2023 and 2024	45

Non-regulated revenue	46
Part 2 – Response to new opinions provided by EI	47
Bottom up analysis	47
Top down evidence	52
Section 6: Pension costs	60
Efficiency adjustment to defined benefit pension costs	61
Pension cost pass-through	63
Defined contribution pension costs	64
Section 7: Capital expenditure, incentives and governance	66
Allowed capex spending and incentives	67
Cost/burden of implementing improved governance arrangements	69
Steer Helios report	70
Section 8: Oceanic price control	72
Technology update – the ADS-B service	73
Other cost efficiencies	74
Relationship between the Oceanic and en route businesses	76
Section 9: Cost of capital	77
Total Market Return (TMR)	79
Asset Beta	82
The risk-free rate	87
Debt Beta	88
Cost of debt	90

Executive summary

Introduction

1. In this submission we respond to the main points raised by NERL in its Statement of Case (SoC) as provided to the CMA on 28 November 2019. We focus on NERL's main paper and a small number of the key supporting documents that provide important new information. Our commentary seeks to explain how NERL's arguments and evidence should be understood in the light of the wider context for the RP3 review, our statutory duties under the Transport Act 2000 and the public interest. We deal with the most important points in this summary, with sections 1 to 9 of this paper providing further detail and covering the full range of issues raised by NERL.

Overview of the main issues raised by NERL and our response

2. NERL's key concerns about our final decisions for RP3 are described in the foreword and introduction to its SoC (and in general address areas similar to those identified in our initial submission¹). In summary, NERL's key concerns² with our final decisions as they relate to its main price control are:
 - a) insufficient allowance for the financial resources to achieve the major technology and airspace modernisation change programmes at the same time as maintaining appropriately high standards of operational resilience, service and performance;
 - b) the imposition of disproportionate burdens on the business through the imposition of new governance incentives which are neither necessary, justified nor likely to deliver better outcomes; and
 - c) not allowing NERL to earn a rate of return that adequately reflects the cost of capital for an efficient air navigation service provider (ANSP) over the RP3 period.
3. We find it difficult to reconcile the concerns expressed by NERL with a broad assessment of our final decisions for RP3. In relation to airspace modernisation we allowed NERL's forecasts of capital expenditure in full and made it clear that all efficiently incurred capital expenditure would be added to its Regulatory Asset Base (RAB). We also allowed all NERL's forecasts of a significant increase in

¹ [CAP 1857](#) Reference to the Competition and Markets Authority of the NERL RP3 price controls [RP3 reference CAA document 002]

² NERL, SoC, paragraph 3

operating costs for its main business over the first three years of RP3 and assumed only modest efficiency gains thereafter. In estimating its cost of capital, we have used an equity beta value of one and so its prospective shareholders rewards have been calculated on the basis of a typical quoted company, which is generous given NERL is a relatively low risk monopoly business with significant regulatory protections against key business risks.

4. NERL also expressed concerns with respect to our final decisions on its Oceanic price control (which makes up about 7% of its price control revenues in RP3). These matters are dealt with in section 8 of this paper.
5. Bearing the above in mind we remain of the view that the modest efficiency challenges for NERL and full allowances for airspace modernisation included in our final decisions for RP3 are in the public interest and are consistent with our statutory duties, including our primary duty to maintain high standards of safety in the provision of air traffic services. We explain our position in more detail below and in the following sections of this paper.

Overarching importance of safety

6. We agree with NERL on the progress made on safety since NERL's creation in 2001 including that Airprox incidents have fallen from an average of 4 category A and B incidents per year to an average of zero category A and B incidents per year.³ We are also strongly of the view that an efficiently managed business, deploying its resources on the basis of a transparent assessment of options and the clear prioritisation of spending, will be best placed to maintain safety standards. In the light of this, and the modest nature of the operating efficiencies identified in our final decisions and the full protection for capital expenditure offered by the regulatory framework, we regard our final decisions as entirely consistent with our primary duty to maintain high standards of safety. Bearing the above in mind we reject the suggestion made by NERL that we have given undue weight to our customer (airspace user) and efficiency duties compared to our safety duty.⁴
7. The regulatory allowances and treatment of expenditures in our final decisions are relatively generous but in any case, an effective management team will always prioritise a high standard of safety irrespective of regulatory allowances. If there were to be any substantive new requirements that would involve levels of expenditure above those envisaged in our final decisions (and given the magnitude of the cost increases we have allowed this seems highly unlikely) it is for NERL to reprioritise its spending to address these issues, provided this does not jeopardise its service delivery. If this is not practicable then it would be for

³ NERL, SoC, page 9

⁴ NERL, SoC, paragraph 143

shareholders to fund these costs until an appropriate regulatory treatment can be agreed.

Importance of the cost of capital

8. The different assumptions on the cost of capital are the most material difference between our final decisions and NERL's revised business plan (RBP). Chapter 13 of NERL's submission deals with the cost of capital in detail. Key to NERL's arguments is that the differences in assumptions on the cost of capital (and the cost of equity in particular) are implausibly large when compared to the assumptions made in setting NERL's RP2 price control in 2014 – because total market return (TMR) has not reduced significantly and/or the systematic risk faced by investors from investing in NERL's business has not fallen.
9. We have approached our assessment of the cost of capital on the basis of our statutory duties, including to protect users, to have regard to NERL's financeability and to promote economy and efficiency. This led us to conduct a wide-ranging assessment of the evidence currently available, including looking at longer-term historical trends as well current and forward-looking market evidence. We did not conduct our review using the assumptions made in RP2 as a base or starting point.
10. This is important in the context of the TMR where there has been an accumulation of evidence that suggests taking a more balanced approach to the assessment of evidence, including giving appropriate weight to current and forward-looking evidence as well as the more traditional analysis of historical returns. Therefore, we are not suggesting that the TMR has fallen by a fixed amount between 2014 and 2019, but rather the balance of evidence is now different, and it is appropriate to reconsider and recalibrate estimates of the TMR on this basis.
11. Similarly, in respect of asset and equity betas we took a fresh look at the evidence on beta values during the RP3 review – including the information that had recently become available for estimating equity betas directly from a listed ANSP. While we note our estimate of equity beta of 1 is somewhat below the 1.1 assumption made in setting NERL's RP2 price control it remains generous to NERL's shareholders. In particular it rewards investment in NERL on the same basis as the average equity investment in the market as a whole when NERL has very extensive protection from business risks, including:
 - it has a monopoly over the provision of en route air traffic services in the UK;
 - the costs of its defined benefit pension scheme are subject to cost pass-through arrangements;
 - it benefits from traffic risk sharing arrangements;

- the regulatory framework allows for the cost pass-through of all efficient capital expenditure; and
- the price control review process provides for the periodic resetting of its revenue allowances and the opportunity to take account of the latest information on cost drivers.

12. Bearing all of the above in mind it is clear there is no reasonable basis for NERL's suggestions that our approach to estimating the cost of capital is inconsistent with our financeability duty and produces an estimate of the cost of capital too low to reasonably incentivise investment. We remain of the view that the estimate for NERL's cost of capital in our final decisions is consistent with the public interest. We set out our response to NERL's arguments on the cost of capital in more detail in section 9.

Wider considerations

13. Not only do NERL's concerns about shareholder returns inappropriately colour its evidence on the cost of capital but they also appear to have a chilling effect on NERL's approach to a wide range of issues. We note that in describing issues relating to the cost of capital NERL suggests that *"setting the allowed rate of return at the right level allows NERL to recover its costs in full, including the efficient cost of raising finance"*.⁵ In contrast we view shareholder returns as the reward for a business that stretches itself to meet efficiency targets and deliver for its customers across a full range of circumstances – not an entitlement for delivering a business plan that is based on significant increases in costs and the softening of service standards.

Airspace modernisation and wider governance

14. We understand the challenges of airspace modernisation and have made significant allowances for both operating and capital costs to facilitate airspace modernisation. We have also accepted the arguments put forward by NERL to make an allowance for the increased level of airspace change in the calibration of its capacity and quality of service targets. We note that effectively managing change is central to the requirements of an efficiently managed business, and in this context the allowances we have made look relatively generous to NERL and its shareholders.
15. In these circumstances, NERL's customers and the users of its services can reasonably expect governance and incentive arrangements that protect them from a failure to deliver by NERL. We accept that these arrangements – and the delivery incentive in particular – have the potential to create downsides for NERL, but only if it fails to deliver its part in airspace modernisation. The

⁵ NERL, SoC, paragraph 41

incentives provide essential protections for airspace users given the important role NERL has in airspace modernisation and its failure to deliver and account for changes in its plans during the RP2 period. Furthermore, we are surprised that NERL is opposing additional governance arrangements that would give its users a greater role in decision-making, given that its customers will be well placed to help inform what services and investments are needed for NERL to most effectively meet the reasonable needs of users.

16. We set out our response to NERL's arguments on airspace modernisation and capital expenditure governance in more detail in sections 3 and 7.

Allowances for operating costs and capital expenditure

17. In relation to operating costs we note that our final decisions involved an approximate 2% reduction in operating costs compared to NERL's RBP. Even after our assumptions on efficiency, our projection of operating costs in 2024 (the last year of the RP3 control) is 15% higher in real terms than NERL's spending in 2017. There also appears to be scope for wide-ranging efficiency improvements by NERL – including in relation to its non-staff costs and non-operational staffing levels.
18. In the light of the above it appears there is no reasonable basis for NERL to suggest that with a 2% reduction in its RBP operating costs it *“would be unable to provide the headcount built into its business plan with the CAA's RP3 Decision, which would create risks to ongoing safety improvements, resilience and other aspects of operational performance”*.⁶ In addition to the modest nature of the efficiency target, NERL's suggestions are counter to the established basis of the economic regulation of private sector monopolies. It is for management to strive to meet reasonably stretching efficiency targets while also delivering a safe and high-quality service and if in this context NERL is unable to meet efficiency targets, then shareholders should fund the shortfall. It is not for NERL's management to plan on the basis of taking risks with resilience or operational performance and they should not suggest that they might operate the business on this basis. We also note NERL's references to safety and while we have confidence that NERL's management team will remain appropriately focused on safety, the drafting of the SoC appears to create some unnecessary ambiguity with respect to these matters.
19. Bearing in mind our relatively generous operating cost allowances we suspect that NERL's narrative about the possible detriment from our assumptions is a response to shareholder pressure on NERL to deliver significant levels of outperformance. We strongly suggest that the softening of efficiency targets in this context would not be in the public interest and we are also of the view that

⁶ NERL, SoC, paragraph 15

appropriate targets and incentives on the quality of service and the delivery of airspace modernisation are appropriate to discourage NERL from inappropriately saving costs at the expense of its customers and the users of its services. Our response to NERL's arguments on operating costs are dealt with in more detail in section 5, quality of service incentives in section 4 and delivery incentives in section 7.

20. We also do not understand the points that NERL is making about our assumptions on its wider capital programme. While we made an overall 7 per cent reduction in its forecast of capital expenditure, the regulatory pass-through treatment of capital expenditure ensures that all efficient spending can be added to NERL's RAB and the costs recovered by NERL through its monopoly charges. We also tested the financeability of NERL's activities using a range of assumptions, which included scenarios with capital expenditure at the level envisaged in its RBP. Therefore, if NERL can demonstrate the efficiency of its spending it will be able to recover the associated level of costs and there can be no question of this approach jeopardising the public interest. We set out our response to NERL's arguments on capital expenditure in more detail in section 7.

NERL processes for customer consultation and finalising its business plan

21. More broadly we are surprised by the way NERL has characterised the process for finalising its business plan and its conduct during the price control review process. We note what NERL says in the foreword to its SoC that "*despite considerable efforts to bridge the gap between these approaches a compromise could not be reached*".⁷ However, NERL's position in its SoC is almost identical to its RBP which in turn was almost identical to the initial business plan it produced in early 2018. Given this, it is not evident that it has made any meaningful efforts to compromise, nor has it revisited its plans in any meaningful way despite detailed feedback from stakeholders that it should do so, and nor has it produced evidence of real stretch or the efficiency targets that we would expect to see in a high-quality business plan.
22. NERL also makes numerous references to its customer consultation processes in its main SoC submission and repeatedly suggests that its approach to these matters justifies its RBP. We welcome the efforts NERL made to consult with its customers and other stakeholders but note that on the key building blocks of its price controls NERL failed to reach agreement with its customers,⁸ including in relation to:

⁷ NERL, SoC, page 10

⁸ See the conclusions of RP3 Customer Consultation Working Group, Report of the Co-Chairs

- resource levels and operating costs;
- pension costs;
- assumptions on the scope for future productivity gains;
- capital expenditure costs; and
- the Oceanic price control.

Scope for outperformance

23. We have explained above our approach to establishing the modest efficiency targets in our final decisions and the allowances we have set to provide NERL the flexibility to play its full part in airspace modernisation. Consistent with this approach an effective management team could deliver its part in airspace modernisation and may also outperform our baseline assumptions on operating costs and quality of service. We also note that NERL says it has “*had to impose what we consider to be short term measures to hold back as many demands as possible on costs on a short-term basis, but avoiding measures which we believe will have irreversible effects on the viability of delivering NERL’s RBP in RP3*”.⁹ This indicates NERL is already targeting cost levels below its RBP and reinforces our view that NERL is seeking to argue for assumptions on costs and incentives that would allow it to claw back from its customers the reductions that we have made in setting its cost of capital and allowed returns between our RP2 and RP3 final decisions.

Decision-making framework and the public interest test

24. In chapter 3 of its SoC, NERL suggests that in our initial submission we had put forward an approach to this inquiry that indicated “*an inappropriate degree of restraint on the CMA’s discretion in the context of a price control re-determination*”. We invite the CMA to conclude that NERL has incorrectly characterised the procedure under s.12 of the Transport Act 2000 (TA 2000) in its SoC.¹⁰ Similar to the regime examined by the High Court in *R. v Director General of Telecommunications Ex p. Cellcom Ltd* [1999] E.C.C. 314 (“*ex p. Cellcom*”), the TA 2000 does not envisage the CMA stepping into the CAA’s regulatory role. This is clear from our responsibility to consider any CMA report following an investigation pursuant to s.12 and determine whether any modifications to licence conditions should be made (s.14(2) TA 2000).

⁹ NERL, SoC, paragraph 39

¹⁰ NERL, SoC, paragraph 147

25. NERL seeks¹¹ to rely on the approach of the CMA in the *Bristol Water* decision.¹² This in fact supports our case, namely that the role of the CMA is to review the price control set by the regulator and consider whether it was right. In particular, at paragraph 3.18 the CMA noted that “*we decided that our approach should build on, but not be unduly constrained by, the analysis already carried out by Ofwat and Bristol Water. We also considered it important that our approach should form part of a coherent overall price control framework for Bristol Water, when taken together with other aspects of Ofwat’s wholesale price control determinations for Bristol Water that we accepted for our determination*”.
26. Further, in a number of places, NERL’s criticism of our final decisions amount to a rationality challenge (see, for example, at SoC paragraphs 146 and 366). It is well-established that there is a high threshold for such a challenge, which will be particularly the case in the regulatory context of this referral.¹³

Other matters

27. NERL has raised a wide range of issues in its SoC (including some of limited materiality) and identified no areas where it expects to outperform its business plan assumptions. For completeness we deal with the main issues raised by NERL in the following sections and for convenience we address these issues in the same order as the 13 main chapters in NERL’s SoC:
- section 1: background and context (SoC chapter 3)
 - section 2: traffic forecasts (SoC chapter 4)
 - section 3: Airspace Change Organising Group (SoC chapter 5)
 - section 4: service quality and environmental targets (SoC chapters 6 and 7)
 - section 5: operating costs and non-regulated revenue (SoC chapters 8 and 9)
 - section 6: pension costs (SoC chapter 10)
 - section 7: capital expenditure, incentives and governance (SoC chapter 11)
 - section 8: Oceanic price control (SoC chapter 12)

¹¹ NERL, SoC, paragraph 180

¹² *Bristol Water plc. A reference under section 12(3)(a) of the Water Industry Act 1991. Report*, October (‘CMA (2015)’), available at https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf.

¹³ See *ex p Cellcom*, pp.331-332 and 334-335 at [26]-[27] and [33] per Lightman J; and more recently *R. (on the application of Gwynt-y-Mor Offshore Wind Farm Ltd) v Gas and Electricity Markets Authority* [2019] EWHC 654 (Admin) at [87]-[89] and [158] per May J.

- section 9: cost of capital (SoC chapter 13).

Section 1

Background and context

Chapter 3 of NERL's SoC covers what it describes as background and context. While many of these issues are picked up in more detail under the subsequent section headings (and we address them there), there are certain issues that are not captured there that require a response. We have concerns with:

- the way NERL characterises its role during RP2 and its failure to properly acknowledge its shortcomings in consulting with its customers and under delivery of important components of airspace modernisation during RP2;
- the suggestion that its business plan has largely been agreed by its customers, when in fact its customers have contested a wide range of the assumptions and deliverables that NERL included in its business plan;
- the incorrect assertion that NERL makes that we gave improper weight to our consumer duty in reaching our final decisions; and
- NERL's inappropriate characterisation of the redetermination process.

Introduction

1.1 The points highlighted are largely dealt with either in our Executive summary above or our original notice of reference and initial submission.¹⁴ In this section we simply reference where the CMA can find our rebuttals of the points made by NERL in relation to:

- NERL's track record of consultation and delivery over RP2;
- its suggestion that customers have agreed its RBP;
- the suggestion made by NERL that we have given too much weight to protect consumers; and
- NERL's inappropriate characterisation of the redetermination process.

¹⁴ NATS (En Route) Plc, Notice of Reference: Determination of price controls for the period 1 January 2020 to 31 December 2024 [RP3 reference CAA document 001] and CAP 1857 – Reference to the Competition and Markets Authority of the NERL RP3 price controls [RP3 reference CAA document 002]

The main points raised by NERL

Experience of RP2

- 1.2 NERL's commentary on its experience during RP2 fails to properly acknowledge two crucial factors – its failure to consult properly with customers (airspace users) on changes to its investment programme and the non-delivery of important elements of airspace modernisation. Our views are explained more fully in our initial submission, see in particular paragraphs 1.29, 2.61 and 2.62.

Customer consultation

- 1.3 NERL's suggestion that its business plan has 'broad customer agreement' does not appear to be accurate – see paragraph 22 in the Executive summary for further information.

Application of our statutory duties

- 1.4 NERL incorrectly asserts that we have misapplied our statutory duties. Paragraphs 6 and 7 in the Executive summary explain that we have taken the overarching importance of safety and our primary duty with respect to these matters fully into account in making our final decisions.

The redetermination process

- 1.5 We explain in paragraphs 24 to 26 in the Executive summary our view that NERL has mischaracterised the decision-making framework and the application of the public interest test in the redetermination process.

Section 2

Traffic forecasts

Chapter 4 of NERL's SoC discusses issues relating to the traffic forecast. Our main concerns with the views expressed are:

- NERL proposes to use its own traffic forecast as opposed to the STATFOR forecast that we used in our final decisions. Historically NERL's forecasts have been less reliable than STATFOR and NERL's forecasts uses assumptions that are not reliable. On this basis we conclude that the use of NERL's forecasts would not be in the public interest.;
- NERL misrepresent our rationale for using the STATFOR forecast by stating that it was due to the independence of STATFOR when in fact this was only a secondary consideration. Our primary rationale was that STATFOR's forecast has been more accurate in 2019 to date, and we also have concerns with the assumptions used in the NERL forecast.;
- it appears the comparisons NERL makes between its forecasts and those of STATFOR are not on a like-for-like basis and may be misleading.

Nonetheless, the CMA may wish to consider the use of an updated forecast for the RP3 period and we understand that a revised forecast will be available from STATFOR in February 2020.

Introduction

- 2.1 In our final decisions, we considered both NERL's traffic forecast and the forecast from Eurocontrol's Statistics and Forecasting service (STATFOR) and decided to use STATFOR's forecast.
- 2.2 NERL's SoC makes two broad suggestions that we disagree with:
- it claims that we used the STATFOR forecast because of its independence and that it is 'consistent with Europe'.¹⁵ However, these reasons were secondary and the main reason was that STATFOR has been more accurate in forecasting traffic in 2019 than NERL, and we also have significant concerns with assumptions that NERL uses in its forecasts; and

¹⁵ NERL, SoC, table 2, p.49

- it suggests that NERL's forecast is more robust than STATFOR's.¹⁶

- 2.3 We address these points below but agree with NERL that the CMA could take advantage of the updated traffic forecasts for RP3 in its redetermination as there have been material changes to the baseline and forecast drivers since the STATFOR February 2019 and NERL May 2019 forecasts. Nonetheless, if the CMA chooses to adopt an updated traffic forecast, it should also consider the impact of any changes in volumes on NERL's costs.
- 2.4 We also note the limited materiality of the difference in the previous forecasts – the STATFOR February 2019 forecast is 0.9% higher than NERL's May 2019 forecast for total service units.

The advantages of the STATFOR's traffic forecast

- 2.5 NERL says that we used the STATFOR forecast because of its independence and consistency with Europe. However, we were clear in our final decisions that the main reason was because the STATFOR forecasts was its greater accuracy in forecasting traffic for 2019. As discussed below, service unit levels at the start of RP3 will likely be 2% to 3% above the NERL forecast. The considerable underestimate of traffic in 2019 to date by the NERL's forecasting model suggests it would not form a reliable basis for a redetermination of NERL's price control and its use would not be in the public interest.
- 2.6 Both STATFOR and NERL forecasts have underpredicted growth in service units in 2019 to date, due to the particularly north-about location of North Atlantic tracks during 2019, which have led to longer distances flown by North Atlantic traffic. However, STATFOR has had a considerably smaller forecast error. Actual service unit growth in 2019 has been 3.4%¹⁷ compared to STATFOR's forecast of 1.8% and NERL's forecast of 0.9%.
- 2.7 NERL notes in its SoC that, on the advice of the Met Office, the positioning of the jet stream should revert to a 5-year average.¹⁸ NERL's forecast assumes that this is achieved by 2020 from a peak in northerly tracks in 2018.¹⁹ We do not disagree that North Atlantic tracks are at a peak and are more likely than not to return to normal levels eventually, but there is no evidence that this will happen as soon as 2020.

¹⁶ NERL, SoC, paragraph 183

¹⁷ Billings data obtained from Eurocontrol Central Route Charges Office (CRCO)

¹⁸ NERL, SoC, paragraph 173

¹⁹ Traffic Support Pack, (SOC011), p.30

- 2.8 Actual flight growth in 2019 has been 1.3%.²⁰ This is halfway between NERL's forecast (0.9%) and STATFOR's forecast (1.7%). However, we note that there has been downwards pressure on flights growth recently due to (i) the failure of Thomas Cook²¹; and (ii) UK GDP forecasts have been reduced recently. The fact that NERL's forecast growth is still lower than the actual suggests that its forecast is much less robust. Had these two events not happened, the actual figure would have likely been much closer to the STATFOR forecasts and the underlying STATFOR forecast appears more accurate and reliable.
- 2.9 Additionally, we note that in its SoC, NERL appears to make comparisons between the historical accuracy of the NERL and STATFOR forecasts that are not on a like-for-like basis and may be misleading. For example, NERL compares STATFOR's 2014 forecast with NERL's 2012 forecast.²² A more appropriate comparison would have been NERL's forecast for RP2 from 2014. Moreover, NERL presents figures for the February 2019 STATFOR forecast that appear to be inconsistent with those published by STATFOR.²³

The assumptions used by NERL in making its forecasts

- 2.10 We set out our concerns relating to the assumptions used in the NERL forecast in our final decisions and do not repeat this analysis in detail but note that the assumptions supporting NERL's modelling do not appear to be subject to rigorous independent peer review or verification. We have particular concerns about the assumptions on aircraft weight as explained further below.
- 2.11 Heathrow and Gatwick airports will both be constrained in RP3 and we would naturally expect to see growth in aircraft sizes at these airports as airlines respond to constraints on runway capacity. The DfT model on which NERL's forecast is based features a dynamic aircraft size module which, all other things being equal, will lead to a gradual move to bigger aircraft sizes at runway constrained airports. Unless NERL has disabled this functionality, NERL's passenger and flight forecasts will likely incorporate increased aircraft sizes in

²⁰ IFR flight data obtained from Eurocontrol Network Manager
We note Service units have grown faster than flights because of the continuing trend in increasing weight factors observed in recent years, as well as increasing average distances flown. This pattern is also observed across Europe too, e.g. see page iii in EUROCONTROL's 'Seven-Year Forecast February 2019' <https://www.eurocontrol.int/sites/default/files/2019-03/eurocontrol-7-year-forecast-february-2019-main-report.pdf>

²¹ Thomas Cook accounted for approximately 1% and 2% in winter and summer months respectively for both flights and service units. The failure of Thomas Cook will likely reduce flights and service units by 0.3% in 2019.

²² NERL, SoC, figure 1, p.52

²³ Traffic Support Pack, (SOC011), P.19-21

the allocation of passengers. However, it appears NERL does not go on to adopt this assumption in its service unit forecast. This can be seen by the NERL forecast having identical flight and service unit growth from 2021 onwards. Historically, service unit growth has exceeded that of flights and with average maximum take-off weight (MTOW) increasing by 19% between 2002 and 2018 for the UK as a whole.²⁴

- 2.12 While NERL puts forward the valid argument that the end of production of the A380 and retirement of B747s will reduce average weight,²⁵ these are used on a relatively small number of long-haul routes. Therefore, the increase in aircraft size at Heathrow and Gatwick airports as a result of runway constraints is likely to more than offset this.
- 2.13 STATFOR assumes some weight growth based on historical data for the UK. This captures some but not all of the effect of increased aircraft sizes at constrained airports – and represents a better basis for forecasting.

Updated traffic forecasts

- 2.14 We agree with NERL that the CMA should use an updated forecast in any redetermination. Both STATFOR and NERL should seek to take into account a number of factors in updating their forecasts, including (i) the loss of Thomas Cook; (ii) the lower GDP growth forecasts and (iii) forecast errors to date. Nonetheless, NERL may have an incentive to provide a lower forecast in its forecast update, to the extent that it believes this forecast will be used for any redetermination.
- 2.15 If the CMA chooses to adopt an updated traffic forecast, it should also consider the impact of any changes in volumes on NERL's costs.
- 2.16 We also note that EU performance regulation for RP3 requires that service unit forecasts be based on actual distance flown, rather than distances on a flight planned basis.²⁶ While such a forecast was not available when we made our final decisions, provisional work done by STATFOR suggested the impact in respect of the UK would be negligible. STATFOR's updated 'M3' forecast will be calculated on an actual distance flown basis. We believe that any updated forecast for RP3 that the CMA may use in any redetermination should be on an actual distance flown basis, consistent with the EU performance regulation.

²⁴ Eurocontrol Service Units Dashboard – Average MTOW per flight (Index), reference year 2002, country UK

²⁵ Traffic Support Pack, (SOC011), p.38

²⁶ Seven-year forecast of flight movements and service units - annex 4, Eurocontrol, February 2019

Section 3

Airspace Change Organising Group (ACOG)

It is common ground between CAA and NERL that it is in the public interest to modernise the design of UK airspace and that this is reflected in government policy. Chapter 5 of NERL's SoC addresses the proposed roles and functions of NERL to establish, maintain and manage the Airspace Change Organising Group (ACOG), to write the airspace change masterplan for the UK (starting with a masterplan for changes in Southern England) and to design a programme management plan for its delivery to facilitate delivery of that modernisation.

It is our view (as well as that of the Department for Transport) that it is in the public interest for NERL to apply its expertise and experience in fulfilling the roles envisaged as the licensed monopoly provider of UK en route air traffic control services. NERL is uniquely placed to play a central role in delivering this programme, and it is important that it is held accountable for delivering the aspects of airspace modernisation that it is responsible for. However, we seek only to hold NERL to account for fulfilling its roles to the best of its ability within the landscape and framework within which it operates, including the policy landscape and levers available to it.

The main areas of disagreement between NERL and CAA relate to the status and funding of ACOG and accountability for the delivery of the airspace change masterplan.

Government policy, and the associated CAA strategy, to modernise UK airspace are not in scope of this reference. The issue in scope is the terms of the proposed licence condition imposed, in the public interest, to support that policy and strategy. In reaching its conclusions on these issues, the CMA will necessarily need to focus on those elements that fall within the NERL RP3 price control and associated licence modifications. In our view, if NERL's roles change as a consequence of the determination of our reference then necessarily the costs allowed will also change.

NERL and the CAA continue to discuss constructively the terms of the proposed licence condition on airspace modernisation and will inform the CMA in the event that we reach an agreed position and this element of the reference can be withdrawn.

Part 1 - Overview of airspace modernisation and the role of ACOG

- 3.1 Our comments on chapter 5 of NERL's SoC, in respect of ACOG, are quite detailed. To provide context, Part 1 of this section provides a high-level overview of airspace modernisation and how the role of ACOG fits in.

- 3.2 The UK Government has a public policy objective that the UK airspace should be modernised so that it can accommodate increasing volumes and types of aircraft safely and expeditiously (see Green Paper for its forthcoming Aviation Strategy).²⁷ It has directed the CAA to create an airspace modernisation strategy and plan to deliver this policy. This strategy was created, consulted on and published in 2018.²⁸
- 3.3 One of the 15 initiatives to deliver this strategy and one of the most significant is the re-design of the UK's airspace structures – the roads in the sky that have not been fundamentally re-designed for many decades. Ownership for the design of these specific routes is split mainly between airports (for routes close to airports) and NERL (for upper airspace routes connecting airports and lower airspace in the London area).
- 3.4 To achieve this re-design, we need a single plan (the “airspace masterplan”) that identifies all the places in which airspace design changes are required and the inter-dependencies between them. This coordinated plan is needed so that we and the Department for Transport (DfT) can take decisions about what changes are required in the best interests of the overall aviation network and the wider public, and not just in the interests of one individual airport or air navigation service provider. Together with DfT, we co-commissioned²⁹ NERL to prepare this airspace masterplan and reflected this commission in the proposed licence condition. NERL is, in our view, the appropriate body to undertake this activity. As the monopoly provider of air traffic services for UK en route and at some London airport approach services, airspace modernisation is a fundamental requirement of NERL's licensed activities. As such, it is the closest body in UK aviation to that of a network operator. Moreover, because of its role as the planner and deliverer of such UK en route and complex terminal air traffic services NERL holds the technical skills required to fulfil the role.
- 3.5 Given the large number of parties involved in contributing to the masterplan, including up to 17 airports and NERL itself for the upper and lower London airspace, we have asked NERL to put in place some additional governance and support arrangements for the creation of the masterplan. This is in the form of the Airspace Change Organising Group (ACOG). This group will operate as a unit within NERL but with an additional layer of governance (a Steering Committee) to guide it to act impartially and to facilitate the production of a

²⁷ <https://www.gov.uk/government/consultations/a-new-aviation-strategy-for-the-uk-call-for-evidence>

²⁸ [CAP 1711](#): Airspace Modernisation Strategy

²⁹ Joint DfT-CAA commission letter dated 2 November 2018. Terms of the commission were published in December 2018 in Chapter 6 Paragraph 6.6 onwards of CAA's CAP 1711: Airspace Modernisation Strategy

masterplan that is in the interests of the whole airspace network and its stakeholders, and the wider public.

- 3.6 Within the framework set by this masterplan, we expect each airport wanting or needing to make an airspace design change, and NERL, to take forward those individual changes in accordance with the regulatory design process we have established. In the event that an individual airport chooses not to take forward an airspace design change that has wider network or stakeholder benefits, the Government is proposing to put in place a legislative power to enable that stakeholder to be directed to make the change or for another stakeholder such as NERL to prepare all or part of the proposal in order that the inter-related changes identified within the masterplan are kept on track. Whilst the proposed legislation is going through the parliamentary process we have proposed including in NERL's licence a provision that allows us (if necessary in the public interest) to instruct NERL to prepare all or part of any proposal. This is in the interests of ensuring there is a mechanism in place for delivering airspace design changes that are in the wider public interest.

Part 2 – Response to NERL's SoC

Introduction

- 3.7 DfT, CAA, NERL and the wider industry agree on the importance of airspace modernisation and that NERL has a key role to play in supporting elements of its delivery.
- 3.8 In our RP3 final decision, we introduced a new licence condition setting out the roles NERL should play. These were based on various trilateral discussions between the DfT, CAA and NERL and bilateral discussions between CAA and NERL. These discussions led to the initial 'commissioning' letter from the DfT and CAA (as airspace modernisation co-sponsors) to NERL, which made clear NERL's commissioned roles would be enshrined in a licence condition. NERL reflected these roles in its RP3 business plan.
- 3.9 Important components of the NERL role include:
1. the establishment, maintenance and management of an airspace change organising group (ACOG);
 2. writing an airspace change masterplan with input from individual airports which will need to make airspace design changes to achieve airspace modernisation; and
 3. delivering the airspace changes in the airspace for which NERL is the provider of UK en route air traffic control services.
- 3.10 In recognition of these roles, our final decisions included:

- NERL's full airspace programme capex;
- £15m of opex for the creation and management of the ACOG; and
- an Opex Flexibility Fund (OFF), that provides a contingency fund to, predominantly, support airspace modernisation related activities.

3.11 In its SoC, and in separate correspondence with us, NERL sets out its concerns and issues in relation to ACOG and the associated licence condition. This section responds to those areas where we disagree with or wish to clarify NERL's characterisation of the issues, in particular it covers:

- the status and funding of ACOG within NERL; and
- delivery of the airspace change masterplan.

3.12 The Government's policy and CAA strategy of UK airspace modernisation is not in scope of the CMA's investigation. The reference to the CMA is limited to whether the imposition of all or part of the proposed licence condition 10a is in the public interest and justified.

3.13 We note that if NERL does not take on the roles and activities envisaged in the licence modification and associated commissioning letter, we would expect there to be a corresponding reduction in the associated cost allowances provided for in the final decisions. To be specific, we mean that if NERL stopped writing the masterplan, the associated cost allowances would not be required. We do not mean that we would necessarily impose a penalty if NERL wrote the masterplan to the best of its ability, but encountered problems with getting the plan accepted by us when we reviewed it.

Status and funding of ACOG

3.14 We do not agree with the description in NERL's SoC of ACOG as an 'independent' organisation.³⁰ We agreed that it would be an impartial unit within NERL. It was also agreed between the CAA and NERL that ACOG should consider interests other than those of NERL. For this reason the impartial unit would sit behind information barriers and be overseen and guided by a Steering Committee (whose members comprise the airports within scope of the commissioned masterplan). ACOG's output will ultimately be assessed and accepted (or not) by the airspace modernisation co-sponsors – the DfT and the CAA. However in corporate law terms ACOG and its employees are accountable to, and the responsibility of, the directors of NERL.

³⁰ NERL, SOC, paragraph 192

- 3.15 The SoC incorrectly implies the RP2 FAS Facilitation Fund (FFF), is a body of the CAA.³¹ The FFF is a mechanism attached to the cost base of, and administered by, NERL. Decisions to approve expenditure on specific projects from the FFF are under the direction of an 'Investment Board', with funding decisions made by industry representatives – we do not have a decision-making role.
- 3.16 The SoC incorrectly states that we did not make an allowance for ACOG funding in our RP3 draft proposals because the associated work was too uncertain.³² This is a mischaracterisation and was not the case.³³ It was our view at the time, that as NERL had identified £15m in its business plan for the establishment of ACOG, as well as writing and coordinating delivery of the masterplan,³⁴ it had included this work and its role as part of its opex proposals. As such, when making our draft proposals on opex efficiency we excluded the ACOG £15m from the opex efficiency challenge to allow this cost in full.

Delivery of the airspace change masterplan

- 3.17 The modernisation of airspace is achieved by making a number of separate but necessarily interlinked and co-dependant changes to airspace design. In the UK changes to airspace design are developed and proposed by the body responsible for that airspace (either airport operator or ANSP (such as NERL)).
- 3.18 Delivery of airspace modernisation is a significant task and will take many years. As such it is necessary to prioritise and focus in the near term on the issues that are most urgent and will have most impact. However, as far as practicable, this must be in the context of ensuring future opportunities are not overly constrained by decisions today.
- 3.19 It is agreed by all parties that such planning cannot be done by any one body in isolation – hence the need to establish some means of coordinating the individual bodies responsible for designing the relevant volumes of airspace.

³¹ NERL, SoC, paragraph 195

³² NERL, SoC, paragraph 197

³³ NERL, SoC, paragraph 197 also incorrectly summarises the rationale for and function of the AMS Support Fund. The CAA component of the UK determined costs for RP3 does include a ring-fenced £10m to finance an AMS Support Fund that third parties (excluding NERL) can apply to for financial support in the delivery of airspace modernisation activities. This is separate from our own airspace modernisation related costs, which are included in our cost base, but not funded from the £10m fund. The AMS Support Fund is analogous to the 'Small Gaps' component of the RP2 FFF and is described in the CAA Decision Document, CAP1830

³⁴ NERL's business plan, chapter 3 page 28 and chapter 7 page 57 (26 October 2018). NB in the business plan the ACOG function is referred to by its former title AMOG

- 3.20 Recognising government policy that increased airspace capacity in the south east of the UK is the current priority³⁵ and likely to have the largest network impact, the design of a masterplan for the Southern England was commissioned first, with a commission in respect of the rest of the UK to follow. It has always been the case that ACOG would at some point be required to produce a masterplan for the rest of the UK. NERL has been aware of that from the outset, we therefore do not agree with NERL's articulation of the task of creating a UK masterplan in the SoC.³⁶
- 3.21 It is not clear from the SoC, whether NERL has misunderstood some of the tasks proposed for it in the draft airspace modernisation licence condition or whether it is now seeking to reject them. In particular, the SoC highlights two main issues, which NERL fails to distinguish between.³⁷
- 3.22 The first issue is whether or not NERL is required under the licence condition to write a masterplan irrespective of the quality and quantity of participation by the (up to) 17 airports in scope of the masterplan for Southern England.
- 3.23 The answer to this is yes. However, in assessing NERL's performance in producing the masterplan, we would expect to take account of nature of the participation of airports in the process and the extent and nature of NERL's engagement with airports to secure their successful participation. Nevertheless, a masterplan must still be produced. The fact that NERL must produce a masterplan irrespective of the amount of participation of the other airports acts as an incentive to those other airports to participate to ensure that their own interests are properly represented and taken into account as the plan is written. It has been recognised by NERL at least since the 2018 co-commission letter that NERL has to produce the masterplan no matter how much other bodies participate – as evidenced by the fact the commission letter asks NERL to identify the degree of commitment offered by each party. As set out above, NERL's role as the monopoly provider of air traffic services for UK en route and at some London airport approach services, means airspace modernisation is a fundamental requirement of NERL's licensed activities. As such, it is the closest body in UK aviation to that of a network operator. Moreover, because of its role as the planner and deliverer of such UK en route and complex terminal air traffic services NERL uniquely holds the information and technical skills required to fulfil the role. No airport, nor the CAA, has such skills and experience.
- 3.24 The second issue is whether or not NERL is responsible under the licence condition for delivering any of the individual airspace changes identified in that

³⁵ See Airports National Policy Statement 5 June 2018 <https://www.gov.uk/government/publications/airports-national-policy-statement>

³⁶ Paragraph 198 of the SoC

³⁷ Paragraph 200 of the SoC

masterplan. (By delivering, we mean preparing and submitting to the CAA for a decision in accordance with our airspace change process, known as CAP1616.)

- 3.25 The answer is that under the licence condition NERL is required to prepare and submit in the first instance only the necessary changes to the airspace which NERL is responsible for as identified in the masterplan. This is en route and some key portions of terminal airspace such as the London Terminal Manoeuvring Area. Airports will need to bring forward airspace design changes for their local airspace.
- 3.26 However, the draft licence condition 10a (paragraph 8) does give the CAA the power, if we choose to exercise it, to require NERL to prepare all or part of another stakeholder's proposal in order that the interrelated changes identified within the masterplan are kept on track. In exercising this power, we would fully envisage consulting NERL and other stakeholders before doing so, and take into account any reasoned and evidenced arguments presented.
- 3.27 NERL is correct that this draft licence condition duplicates to some extent the powers being sought in the Air Traffic Management and Drones Bill. Under the proposed powers in the Bill, the Secretary of State will be able to require an airport or ANSP to prepare and submit an airspace change both in the airspace they are responsible for and in the airspace for which another body is responsible. The policy intention is that once written, due to the complexity of the interrelatedness of the proposed airspace changes identified in the masterplan, the overall plan can only be successfully delivered if the various participants bring forward their changes at the time envisaged by the programme plan in the masterplan.³⁸
- 3.28 The policy intention behind the provision in the draft licence condition (paragraph 8) was that in the absence of those powers (i.e. while waiting for them to go through the Parliamentary process) it would be in the best interests of the public if NERL's licence included this contingent condition in order to keep the masterplan on track. Further, the condition would incentivise the other bodies to work on and bring forward their own airspace change proposals in accordance with the timing in the programme plan within the masterplan. If they did not, there would be the possibility that NERL could be required to develop the change instead, and the initial body would have less influence over the design and the benefits it could achieve.

³⁸ Consultation Response on Legislation for Enforcing the Development of Airspace Change proposals
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/841247/consultation-response-on-legislation-for-enforcing-the-development-of-airspace-change-proposals.pdf

- 3.29 If the government policy intention to bring forward the Bill changes or if the Bill is passed and the Act in force, we will reconsider this sub-paragraph of the NERL licence in that context and, if applicable, propose a suitable amendment.
- 3.30 We consider that NERL, as the monopoly provider of air traffic services for UK en route and at some London airports approach services, holds the necessary technical skills to comply with this contingent condition. The condition would only be applied if it was necessary for us to require NERL to work on all or part of a design change proposal in the public interest, in other words to work towards airspace modernisation to benefit the wider UK airspace network and its users. NERL already has experience in developing airspace change proposals in airspace for which other bodies are responsible.
- 3.31 If the contingent licence condition was in force and exercised, we would not expect that work to be financed out of the £15m of opex ringfenced for the creation and management of the ACOG, rather we would consider it reasonable for NERL to seek to meet its efficient costs from the Opex Flexibility Fund³⁹ and capex mechanisms envisaged in RP3.
- 3.32 It is not clear from the SoC whether NERL holds the opinion that we intend for NERL to write the masterplan and prepare and submit all the required airspace change proposals set out within it.⁴⁰ For the avoidance of doubt, we would expect NERL to develop airspace design proposals for the airspace it operates in any event, but only ask NERL to deliver changes outside the airspace it operates where we felt it necessary to maintain the critical path for the implementation of the masterplan. We intend for NERL's impartial unit ACOG to write the masterplan with (where possible) participation of the relevant airports. ACOG will also coordinate delivery by providing programme management functions to allow relevant entities – including airports and NERL – to deliver the airspace change proposals set out in masterplan.
- 3.33 The SoC asserts that there are a number of inconsistencies between the draft licence condition and what NERL says it has agreed with the airspace modernisation co-sponsors.⁴¹ We have addressed these above, and will conclude this section with a direct response on each bullet point in which NERL raises these inconsistencies:

³⁹ CAP 1830 - UK RP3 Decision Document, paragraphs 9.30 and 9.46. CAP 1830a - Appendices, paragraphs I23 and I38

⁴⁰ NERL, SoC, paragraph 200

⁴¹ NERL, SoC, paragraph 201

- Bullet 1: We do not agree that the conflict identified exists. As addressed above, this is dealt with by the information barriers, the ACOG Steering Committee and co-sponsor governance and ultimate decision-making function.
- Bullet 2: NERL appears to have conflated the roles of writing the masterplan and a preparing programme for its delivery, with actual delivery by the relevant stakeholders of the individual airspace change proposals within the plan.
- Bullet 3: We do not agree that the licence condition expands the geographical scope of masterplan it is required to write. It has always been the case that the plan would encompass the whole of the UK (see in this regard NERL's business plan chapter 3 page 28 and chapter 7 page 57). The commission asked NERL to prioritise a plan for the southern UK for the reasons and government policy set out above. We therefore disagree with NERL that a requirement to write a plan for the whole of the UK in due course, is not included in the opex allowance of £15m for ACOG. If NERL is required to bring forward an airspace change proposal in airspace for which another body is responsible, we consider that it would be appropriate for it to seek to meet its efficiently incurred costs from the OFF and capex mechanisms as appropriate.
- Bullet 4: The issue of and rationale for replicating powers in planned primary legislation is set out above.
- Bullet 5: We recognise that if NERL were to be asked to bring forward an airspace change proposal relating to airspace for which another body is responsible this would bring additional challenges as compared to preparing their own airspace change proposal. The proposed primary legislation addresses this by including a power to require the airport to cooperate. However, the licence condition methodology is, as we have set out, an interim measure included in the public interest to so far as possible keep the masterplan process and airspace modernisation on track. NERL's licence cannot mandate airports to cooperate. While we recognise the additional challenges of bringing forward an airspace design change for airspace for which NERL is not the operator, we are confident that NERL has the technical expertise and experience to do so if necessary, and could secure access to the local community engagement skills required. Moreover, we consider that other stakeholders will be incentivised to cooperate in the knowledge that if they fail to do so, NERL would intervene and they will reduce their opportunities to shape the outcome.