

Reference to the CMA of NERL RP3 price controls: CAA response to provisional findings

CAP 1910

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Civil Aviation Authority, 2020

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Overview

Introduction

1. In this submission we set out our response to the CMA's provisional findings (PFs) report into the NATS (En Route) Plc/CAA Regulatory Appeal, published on 24 March 2020.¹ Appendix A, setting out more detail on our views on how the CMA should take account of the impact that Covid-19 in its final report, will be published separately (as CAP 1910A) by 30 April 2020.

Main issues addressed in this response

2. The Covid-19 pandemic has reduced air traffic movements in UK airspace by around 90%. This has created very large challenges for the aviation sector, including in respect of the liquidity and financeability of the businesses of many sector participants, including NERL. In these circumstances NERL's price control does not provide levers that can deal with issues such as liquidity – as at present there is simply insufficient air traffic to reasonably support NERL's business activities. In this extraordinary situation we consider it is for NERL's management, its providers of finance and Government to determine how best to address short-term issues associated with liquidity and financeability.
3. The present circumstances are unprecedented in terms of both the immediate impact on the sector but also in relation to uncertainty about the recovery of air traffic in the future. Previous incidents (such as the 9/11 terrorist attacks or the 2008 financial crisis) have caused significant dips in traffic but not a complete collapse in traffic volumes with little indication of the timing or shape of any recovery. In these circumstances our view is that the best the CMA can do in terms of establishing price control arrangements is come to a final decision in this referral procedure, which can form interim backstop arrangements, to cover at least the period 2020 and 2021. We would then re-open these price control arrangements in 2021, when the timing and shape of the recovery in air traffic should at least be starting to become clear. As noted above we will set out more detail on our proposed approach to these matters in appendix A, which will be published separately.
4. In terms of the interim backstop arrangements our view is that these could be based on the CMA's PF's, with the CMA retaining the level of allowed price per service unit as in its PFs. In the extraordinary circumstances of a collapse in demand and the inability of the residual level of air traffic to support substantively

¹ [NATS \(En Route\) Plc/CAA Regulatory Appeal Provisional findings report – 24 March 2020](#)

higher levels of charges, and bearing in mind our proposal to re-open NERL's price controls in 2021, the CMA may take the view that little purpose would be served by further fine tuning of its PFs.

5. Nonetheless, there were three issues that the CMA discussed in its PFs that we respectfully suggest merit further consideration – the overall balance of the CMA's approach, the treatment of non-regulated revenue and costs, and its approach to estimating asset beta. As we have noted above, the circumstances of the interim price control arrangements may mean that there is relatively little to be gained by adjusting the level of the PFs, but we would urge that the CMA responds at least in principle to the points we make, as the CMA's approach to these matters may set an important precedent for the future.
6. We have also responded to the CMA's request and provided a draft policy statement in respect of *ex post* capex efficiency assessment and have set out a draft capex engagement incentive. Arrangements for capex governance will be important irrespective of the outcome of the process for re-opening the price controls in 2021 and we propose that the CMA works to develop final arrangements with respect to these matters. Subject to the CMA's final report, we will consult with stakeholders on both, prior to implementation.
7. The substance of our response is provided in this main overview section, with appendices providing additional detail. The remainder of this response is structured as follows:
 - The impact of Covid-19 on air traffic
 - General views on the overall balance of the provisional findings
 - More detailed comments and observations, on the following:
 - Opex, capex and pension allowances
 - Pension regulatory policy statement
 - Safety, service targets and incentives
 - Traffic forecast
 - Capex governance and incentives
 - Non-regulatory income
 - Cost of capital
 - Oceanic ADS-B
 - Appendices: capex incentives, non-regulatory income and the cost of capital

Covid-19

Context

8. The CMA has noted that most of its analysis and conclusions leading up to the publication of its PFs were based on evidence and data, and the operational and strategic context, that pre-dates the Covid-19 pandemic and its impact on the aviation sector.
9. The immediate impact of Covid-19 has been a very significant drop in air traffic volumes through March and into April 2020. While the detailed picture remains subject to daily variation, in broad terms actual traffic is presently about 90% below forecast levels. The immediate consequences of this are that NERL's revenues (which derive from the allowed unit charge per service unit for 2020 multiplied by the actual number of service units) have fallen very significantly. Moreover, given the severity of the impact on airline liquidity, Eurocontrol States have agreed measures² allowing airlines to defer the payment of air navigation charges for February to May 2020, until late in 2020 and well into 2021. This will further impact NERL's revenues, liquidity and financeability in the short to medium term.

Way forward

10. The collapse in air traffic volumes is unprecedented and creates an extremely challenging context for the aviation sector. In these extraordinary circumstances price control levers have little impact on NERL's short-term liquidity and financeability – as air traffic volumes have collapsed and airlines would be unable and/or unwilling to pay higher air navigation charges. Therefore, it is for NERL's management, its providers of debt and equity finance and Government to decide how best to mitigate and deal with the immediate crisis. Our priority is to ensure that its price control arrangements are fit for purpose when the recovery in air traffic volumes start to emerge. Given it is likely to be many months until it is possible to determine the path to recovery or sensibly begin to understand the lasting impact on the sector we, intend to re-open NERL's price controls in 2021 to address these matters. In the between time, our view is that the CMA should finalise its PFs based broadly on the level of allowed revenue per service unit it has already identified. To the extent it carries out further substantive work this should focus on the areas that are likely to be relevant and important precedent for the regulatory framework in the medium term. As noted above our view of these areas is that they should at least cover the overall balance of its approach, the treatment of non-regulated revenue and costs, its approach to estimating asset beta and the arrangements for capex governance.

² <https://www.eurocontrol.int/press-release/eurocontrol-states-assist-airlines-11bln-deferral>

11. We will provide more detail on the approach we intend to adopt to re-opening NERL's price control arrangements in appendix A, which will be published separately.

EU process

12. Recognising that the main NERL price control forms part of the broader UK Reference Period 3 (RP3) performance plan under the EU performance scheme, we note that the European Commission is also considering how best to take account of Covid-19 in assessing Member States performance plans against the EU targets. It has proposed to delay its formal decisions on the (in)consistency of Member States plans with EU targets, to allow Member States to submit updated plans by October 2020 to address Covid-19. We will maintain a watching brief on the EU process and keep the CMA informed of related developments.

General views on the provisional findings

13. Bearing the above context in mind we summarise below our comments on the CMA's PFs.

Overall balance

14. We note that the CMA's overall approach appears to involve the critical assessment of the adjustments that we proposed to NERL's business plan. While we regard this as an essential component of a robust inquiry process we question whether this approach alone is sufficient for the CMA to properly and appropriately discharge its functions with respect to our reference to the CMA of NERL's RP3 price controls. In particular, to properly protect the users of NERL's services the CMA should not be simply adjudicating on the differences between us and NERL, but also actively probing and analysing whether we have been sufficiently stringent in the assumptions we made, with a view to ensuring the CMA's final report properly protects the interests of users.
15. We find relatively little evidence of such an assessment and analysis in the PFs. Bearing in mind the highly unusual position that the CMA now finds itself in, with respect to the developments associated with Covid-19 and the advantages of re-opening NERL's price controls in 2021, we propose that the CMA adopts a pragmatic approach to these matters and clearly signals that a normal part of the process for finalising its decisions would be to test whether its findings properly protect the interests of users over the period of the price control, even if more limited changes are appropriate in the circumstances of a transitional arrangement before a further review of the price controls in 2021.

Operating costs, capital expenditure and defined benefit pension cost allowances

16. We welcome the broad support in the PF's for the adjustments we made to NERL's business plan in terms of operating costs (opex) capital expenditure (capex) and defined benefit (DB) pension cost allowances. These revised allowances were designed to fully support the Airspace Modernisation Strategy (AMS) that remains important in terms of delivering longer-term benefits for users and the wider environment.
17. Nonetheless, we made our final decisions in summer 2019, and even before Covid-19 there were significant changes to the operational and strategic context that have affected NERL's plans. Particular examples include the delay and then mothballing of runway capacity expansion at Heathrow airport and the TC Foursight component of NERL's DSESAR programme. In light of these and other changes to NERL's planned programmes, it is reasonable to consider whether there should be further reductions in NERL's opex and capex allowances in order to properly protect the interests of the users of NERL's services. However, we recognise that in the context Covid-19 a more in-depth review of NERL's planned programmes and costs will be necessary when there is a better understanding of the longer-term impact of the pandemic on air traffic and the aviation sector more generally. As noted above we plan to undertake this work in 2021.

Pensions regulatory policy statement

18. As noted above, the PFs support our approach to setting the allowance for defined benefit pension costs and recommend that we clarify the pension cost pass-through. The PFs state that we could provide such additional clarification through a regulatory policy statement (RPS) for pensions, as discussed in our final decisions.
19. We agree it would be helpful to publish these clarifications as part of an RPS and expect to consult stakeholders on the RPS before it is finalised.
20. In light of Covid-19, we recognise that an in-depth review of NERL's pensions costs may be necessary when there is a better understanding of the longer-term impact. We intend to address these matters as part of the re-opening of NERL's price control arrangements in 2021.

Safety, service targets and incentives

21. The PFs also support our decisions in respect of safety, capacity and environmental targets, and associated incentives. Similar to opex allowances, it is recognised that the capacity targets and incentives allow considerable flexibility for NERL. Such flexibility remains appropriate to support the AMS.

22. We note that the European Commission has recently raised some comments on the UK RP3 performance plan, in particular on the level of the NERL C2 capacity target and incentives.³ As noted in paragraph 12 above, it is considering its timeline and processes in response to the significant impact of Covid-19 on global air traffic. We will engage with this process as appropriate, including in respect of UK capacity targets and incentives.
23. Given the potential impact of Covid-19, we also consider there is merit in reviewing the environmental and capacity target levels, and associated incentives, as part of the review we plan to undertake in 2021.

Traffic forecast

24. The PFs support our final decisions in the use of the STATFOR forecast for the setting of the main RP3 price control.
25. Covid-19 has had a significant impact on the plausibility of available forecasts, and it will be a considerable period of time before the existing level of uncertainty reduces significantly and for plausible forecasts of future air traffic volumes to start to emerge. These matters are best considered in the review we plan to undertake in 2021.

Capex governance and incentives

26. While the PFs make some significant changes to our proposals for capex governance and efficiency incentives we are content to accept the CMA's broad approach as the basis for future arrangements. We make some detailed suggestions for taking forward aspects of these proposals consistent with the CMA's suggestions in its PFs. Before these arrangements are finalised we recommend further consultation with the users of NERL's services. Nonetheless, our present view is that these new arrangements should endure throughout the RP3 period and should not be the focus of our review to re-open NERL's price controls in 2021.
27. The PFs agree with our decisions in respect of the proposed enhanced role of the Independent Reviewer (IR) in the capex governance process. We consider the IR has an important role to play in terms of:
 - enhancing airspace users' understanding of NERL's complex programmes leading to more meaningful engagement;

³ For completeness, the European Commission has additionally raised comments on the scope of ANSPs covered by the UK safety target and the mandated, but not financially incentivised, horizontal flight efficiency target. Neither is related to the matters raised in our reference to the CMA on NERL's RP3 price controls.

- providing NERL with insights on areas to improve the quality of its engagement; and
- helping the CAA, and all stakeholders, understand whether NERL is progressing its programme in an efficient manner.

28. The PFs questioned the level of detail set out in our decisions and made recommendations that we develop further detail around how we would conduct an *ex post* capex efficiency assessment and suggest the development of an engagement incentive (in place of our proposals for delivery and information incentives). These matters are addressed further below and in appendices B and C.

Ex post efficiency assessment

29. The PFs agreed with the principle of an *ex post* efficiency assessment, but considered that we had not explained in sufficient detail how it would work. The CMA proposed that there should either be a licence condition or regulatory policy statement (RPS) setting out how we would conduct our efficiency assessment.
30. We consider that an RPS is the most appropriate way to provide further detail as the purpose of NERL's licence is to set out obligations on NERL rather than the CAA. At appendix B we set out a draft RPS, addressing the matters raised by the CMA in its PFs. Subject to the CMA's final report, we would expect to consult stakeholders on the RPS, prior to formalising it in due course.

Engagement incentive

31. We are pleased that the CMA has recognised the importance of incentivising NERL to engage properly with stakeholders. At appendix C we set out a draft engagement incentive, building on the principles set out in the PFs. Subject to the CMA's final report, we would expect to consult stakeholders on the engagement incentive, prior to implementing it.

Non-regulatory income

32. The PFs do not support the £24 million opex efficiency challenge related to non-regulated income in our final decisions. The CMA considered that our approach could represent double counting, was excessive compared to the opex reduction for regulated revenue, was relatively arbitrary and that NERL had subsequently provided more supporting evidence for its position on how the changes in costs of providing non-regulated services had been reflected in its business plan.
33. We remain of the view that it is important to reassure users and create appropriate incentives for NERL with respect to providing robust forecasts in its business plan of non-regulated revenues and costs. Further, that the level of price control revenue that users of monopoly services are expected to fund should not be inflated by conservative estimates of non-regulated revenues and/or

by failing to make making appropriate allowances for the impact of the costs of non-regulated services. We consider that the CMA has not placed sufficient weight on these matters and evidence of our advisers (and stakeholders) that NERL had not demonstrated sufficient ambition in its non-regulated revenue forecasts.

34. We also note that our efficiency adjustment represents only 5% of NERL's non-regulated revenue forecast for RP3. While we consider that our assessment was a judgment based on the evidence made available at the time, and we recognise NERL has since provided some more evidence to the CMA, we do not accept that it is reasonable to characterise the adjustment that we made as creating a significant danger of double counting or that it was excessive. Nor do we accept that the additional information that NERL has provided fully justifies its business plan assumptions on non-regulated costs and revenues. We explain our views further on these matters in appendix D.

Cost of capital

35. The PFs support our decisions on a number of the parameters of the allowed cost of capital (WACC), though takes a different approach to our decisions in some areas, most notably on the asset beta and gearing.
36. We accept the PF ranges and point estimates for the following specific parameters, including where the CMA has updated parameters for more recent market information:
- total market return (TMR). We broadly support the CMA's approach and while we consider that forward-looking evidence may be useful as a cross-check, we note this supports the TMR range in the PFs; and
 - inflation and risk-free rate. We agree with the approach in the PFs and the estimates reflect more recent market information than used for our final decisions.
37. On the asset beta, we consider that the CMA should place more weight on the ENAV beta (as ENAV reflects the closest comparator to NERL) and we have identified a number of methodological issues and statistical anomalies in the PFs. Correcting for these leads to upward and downward adjustments, but overall suggests the asset beta range should be lower than in the PFs. We explain our views further in appendix E.
38. We support the CMA's overall approach to cost of debt but have identified two specific areas where we consider the CMA has over-estimated the cost of debt. We explain our views further in appendix E.

39. In light of the Covid-19 pandemic, we would expect to build on the CMA's work on the allowed WACC in re-opening NERL's price controls in 2021, while also taking account of new information that may emerge.

Oceanic ADS-B

40. The PFs supported our decision to implement a mid-period review of the costs and benefits of the introduction of the use of ADS-B surveillance for NERL's Oceanic services – and the associated data charge.
41. We welcome the support for the mid-period review and will continue to engage with stakeholders on appropriate metrics and the approach ahead of commissioning the review. However, we consider there should be some flexibility in the timing of the review, to reflect the impact of Covid-19 on traffic volumes.
42. Notwithstanding, the significant downturn in global air traffic, including transatlantic routes, will impact the capacity and flight-efficiency case for the use of Oceanic ADS-B. We consider that it would be appropriate for NERL to explicitly set out whether it intends to continue to utilise space-based ADS-B during the downturn in traffic, and on what basis.

APPENDIX A

Responding to Covid-19

To be published separately as CAP 1910A.

APPENDIX B

Ex post capex efficiency assessment

Context

- B1 In its PFs, the CMA invited the CAA to develop a policy statement that better explained how we would judge any disallowance of capital expenditure (capex), following an *ex post* efficiency review.
- B2 The draft regulatory policy statement (RPS) below takes into account the PFs, along with other regulatory precedent, to set out the principles and procedure we would expect to follow in determining whether any of NERL's capex should not be included in the regulatory asset base (RAB) at the next price control review. We will take account the CMA's final report and consult NERL and other stakeholders before finalising this RPS.
- B3 In developing this draft RPS we have considered the following:
- our statutory duties, which include a duty to have regard to NERL's financeability;
 - precedent from *ex post* reviews we have carried out as the economic regulator for Heathrow airport;
 - the 'Demonstrably Inefficient and/or Wasteful Expenditure' (DIWE) model used in the economic regulation of the energy sector;
 - user support for capex projects and the evidence base for our decisions on capex efficiency in RP3 which will be enhanced by the strengthened role of the Independent Reviewer (IR); and
 - the timing of the *ex post* reviews, noting that some capex projects may span more than one regulatory period.
- B4 We note that over the last 20 years we have only made two disallowances from a RAB, neither of which related to NERL. We disallowed some of Heathrow airport's Terminal 3 Integrated Baggage capex as it was demonstrably inefficient; and disallowed the Personal Rapid Transit system capex as it did not have the approval of users, involved a degree of technological and commercial risk that would be shared with users without sharing the potential commercial benefit, and did not have a proper business case. By way of background, we explain further the context to these decisions in the final section of this appendix.