

Economic regulation of NATS (En Route) plc: Consultation on licence modifications and guidance

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About this document

This consultation relates to the price controls for NATS (En Route) plc's (NERL's) regulated activities under its air traffic services licence for the period 2020 to 2022. It follows on from our August 2019 RP3 price control decisions, the subsequent reference to the Competition and Markets Authority (CMA) and the CMA's final report on NERL's price control arrangements. The consultation is pursuant to the statutory requirements, under the Transport Act 2000 (the Act), to consult on licence modifications before implementation.

The document encompasses:

- having regard to the CMA's final report, the modifications to the licence conditions that we think are needed to remedy or prevent the adverse effects specified in the final report;
- our proposal to introduce a new condition to NERL's licence establishing processes and procedures to coordinate airspace modernisation (Condition 10a – Airspace modernisation);
- some minor licence modifications to improve the clarity of certain obligations created by the licence; and
- a consultation on guidance relating to NERL's capital expenditure incentives.

Views invited

We welcome representations on the licence modifications and guidance set out in this document to economicregulation@caa.co.uk by 21 October 2020.

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 have any questions on this document please contact Rod Gander at rod.gander@caa.co.uk.

Summary and introduction

In autumn 2019, NERL rejected the CAA's proposals for new RP3 price controls and these matters were referred to the Competition and Markets Authority (CMA) to determine.

The significant impact on global aviation of the Covid-19 pandemic became apparent in spring 2020, but after the CMA had conducted its substantive analysis on the RP3 reference. Following its provisional findings, the CMA conducted a further consultation on what approach it should adopt to reflect the impact of Covid-19. The CAA, NERL and some other stakeholders proposed that the CMA could not reasonably take account of the impact of Covid-19 in its final report, as there would still be material uncertainty on its impact on air traffic management for the foreseeable future, and that the CMA should proceed to final report on the basis of its pre-Covid-19 provisional findings. The CAA also committed to conduct a further review of NERL's price controls when better information about the impact of Covid-19 was available.

The CMA made its final report to the CAA in July 2020, which was substantively based on its provisional findings. To reflect the ongoing uncertainty in relation to the impact of Covid-19, the CMA determination covered only the period 2020 to 2022 inclusive, rather than the full five-years of RP3. It also envisaged that the CAA would bring forward new price controls sooner if suitable information becomes available.

Under the Transport Act 2000, the CAA must propose and consult on the licence modifications it considers necessary to remedy or prevent the adverse effects specified in the CMA report, and also have regard to the modifications specified by the CMA. The CMA report is clear on the adverse effects and has specified the modifications it considers necessary to remedy those effects – and these modifications are dealt with in this consultation.

The CMA also set out its views on the necessary accompanying guidance for capital expenditure incentives. We are therefore also consulting on guidance consistent with the CMA report.

Through the development of our RP3 programme of work we have been clear that NERL, as the licensed monopoly provider of air traffic services, should have a key role in supporting the development and implementation of airspace modernisation in the UK. While the context has changed as a result of Covid-19, there remain benefits from an appropriately scoped strategy and programme. Therefore, in addition to the modifications referred to in the CMA report, we are also consulting on a new licence condition in respect of airspace modernisation, which places an obligation on NERL to set-up and manage an Airspace Change Organising Group (ACOG) and develop an airspace change masterplan in support of the UK Airspace Modernisation Strategy.

This consultation also covers a number of minor changes to NERL's licence designed to improve the clarity of certain of the obligations on NERL created by the licence.

Introduction

1. NATS (En Route) plc (NERL) is the monopoly provider of en route and certain approach air traffic services (ATS) in the UK. NERL is currently subject to economic regulation of its en route services both under the European Union Single European Sky (EU SES) performance scheme, and the Transport Act 2000 (the Act) and licence conditions. We are required by the performance scheme regulation to set targets and incentives for NERL with regard to four key performance areas – safety, capacity, environment and cost efficiency – over five-year reference periods. The targets and incentives are part of the UK Performance Plan for RP3.¹ NERL's licence also includes a five-year price control for its charges for air traffic services for flights through airspace over parts of the Atlantic Ocean (Oceanic service).
2. The current Reference Period (RP3) started on 1 January 2020 and will end on 31 December 2024. On 29 August 2019 we published our price control decisions for NERL in the UK Performance Plan and Oceanic charges for RP3.² These decisions (our "RP3 decision") were rejected by NERL³ and on 19 November 2019 we referred the matter to the Competition and Markets Authority (CMA) under section 12 (s.12) of the Act for resolution.⁴
3. On 23 July 2020 the CMA sent us its final report on the reference.⁵ The CMA determined that appropriate modifications to NERL's licence were required to enable us to exercise regulatory control over NERL in RP3 so that NERL was constrained in setting higher prices than necessary. The CMA considered that the outcomes the licence modifications should achieve are to:

¹ In the event that the UK leaves the EU without an agreement it is proposed that the provisions in The Air Traffic Management (Amendment etc.) Regulations 2019 would revoke the EU SES Implementing Regulations and so our economic regulation of NERL would be based solely on the provisions in the Transport Act 2000 and the CAA's licencing scheme.

² [CAP 1830 – 'UK RP3 CAA Decision Document' \(August 2019\)](#)

³ [NATS \(En route\) Plc/CAA Regulatory Appeal – Final Report \(August 2020\)](#) – paragraph 2.65, page 30

⁴ [NATS En route Limited \(NERL\) Price Determination case page on CMA website](#)

⁵ [NATS En-route PLC/CAA Regulatory Appeal – Final report \(August 2020\)](#)

- allow an appropriate remuneration of NERL's investments, properly reflecting the risks to which investors are exposed;
- provide NERL with financial resources to achieve airspace modernisation while maintaining reasonable pressure to continue to deliver operational efficiencies;
- provide appropriate incentives to protect the quality of service to airspace users;
- strengthen NERL's accountability for carrying out its investment plans by putting in place appropriate incentive arrangements and encouraging NERL to develop new and improved governance arrangements; and
- provide for technological enhancements in the Oceanic service necessary to create safety benefits.

4. In particular, the CMA determined that NERL's licence should be modified to implement:

- new price controls for NERL's Eurocontrol, London Approach and Oceanic services. The Oceanic price control allows NERL to recover the costs of using newly-introduced satellite surveillance data. The price controls were for three years from 2020 to 2022;
- an enhanced role for the Independent Reviewer (IR) of NERL's capital expenditure (capex);
- quarterly updates on NERL's Service and Investment Plans (SIPs);
- a new capex efficiency incentive, with reference to a Regulatory Policy Statement (RPS) on its operation; and
- a new capex engagement incentive, with reference to CAA guidance on its operation.⁶

⁶ The CMA set out the licence modifications it expected us to make in appendix F of its final report

Licence modifications

5. Having regard to the CMA's final report, the modifications to the licence conditions that we think are needed to remedy or prevent the adverse effects specified in the final report, and on which we are inviting representations, are:
- Condition 10 – Business Plans, Service and Investment Plans and Periodic Reports. This Condition sets out capex governance requirements on NERL
 - Condition 21 – Control of Eurocontrol Service Charges
 - Condition 21a – Control of London Approach Charges
 - Condition 22 – Oceanic Charges
6. We are also inviting representations on:
- a proposal to introduce a new condition to NERL's licence establishing processes and procedures to coordinate airspace modernisation (Condition 10a – Airspace modernisation); and
 - some minor licence modifications to improve the clarity of certain obligations created by the licence.

Guidance

7. In its final report, the CMA said that it was appropriate to set out our approach to the capex efficiency incentive and capex engagement incentive in a regulatory policy statement and guidance, respectively. Furthermore, the CMA noted that these should be available alongside Condition 10 when it is consulted on. While not subject to the statutory provisions of the Act, through this consultation we are seeking stakeholder views to assist with the process of finalising:
- the draft RPS for the capex efficiency incentive; and
 - the capex engagement incentive draft guidance.

Legal framework

8. The statutory requirements and processes for modifying NERL's licence are set out in the Act. The requirements and processes are different for those conditions that were within the scope of the CMA's reference and those that were not.

Licence modifications following a reference to the CMA – implementation of CMA determination

9. Under s.14(2) of the Act, following receipt of the CMA's final report, we must suggest such modifications of the licence conditions as we think are needed to remedy or prevent the adverse effects specified in the final report. Under s.14(3) and (4) of the Act, before making the suggested modifications, we must have regard to the modifications specified in the final report and publish a notice setting out our suggested modifications, stating their effect and the reasons for proposing them, and stating a period of not less than 28 days within which representations may be made regarding the suggested modifications. This document constitutes such a notice (the "s.14(4) notice").
10. Following this consultation, under s.14(5) of the Act we are required to give notice to the CMA (the "s.14(5) notice") setting out our suggested modifications to implement its determination and the reasons for the suggestions. We must also send the CMA any representations made in response to the s.14(4) notice.
11. Under s.15(2) of the Act the CMA may direct us not to make any or certain of the suggested modifications notified to the CMA in the s.14(5) notice, but it may do so only if it thinks the modifications set out in our notice are not modifications which are needed to remedy or prevent the adverse effects specified in the CMA's final report. If the CMA does not direct us, we must make the modifications set out in the s.14(5) notice.
12. If the CMA directs us not to make some of the suggested modifications, we will not make any such modifications, but we must make those modifications to which the CMA's direction does not apply.
13. If the CMA directs us not to make any or certain of the suggested modifications, the CMA shall, under s.16(4) of the Act, publish a notice inviting representations on such modifications it thinks are needed to remedy or prevent the adverse effects specified in its final report. The CMA must, taking account of any representations it receives, then make such modifications to the licence conditions as it thinks are needed to remedy or prevent such adverse effects as are specified in its final report and, where the CMA has directed us not to make certain of the suggested modifications, which would not be remedied or

prevented by the modifications we proposed and to which the CMA's direction does not apply.

Other licence modifications – airspace modernisation and modifications to improve clarity

14. Under s.11(1) of the Act we may modify the conditions of a licence if its holder consents to the modifications. NERL has agreed to the modification proposed to introduce Condition 10a (in the form attached to this document at appendix B) and to the minor changes summarised in chapter 3.
15. Under s.11(2) and (3) of the Act, before making modifications to a licence the CAA must publish a notice setting out the proposed modifications, their effect and the reasons for the proposal. The CAA must also state the period (of not less than 28 days) within which representations may be made regarding the proposed modifications. This document constitutes such a notice. Detail of the modifications, their effects and the reasons supporting the modifications are set out in chapters 2, 3 and appendices B and C.

NERL 2020 charges

16. NERL's allowed charges to users for 2020 were set according to our RP3 decision. The CMA's final report and determination decided on a higher level of allowed costs, and therefore higher charges. As part of the work we intend to do in 2021 we will consider how best to allow for any revenue corrections for 2020 and 2021, given the extraordinary impact of Covid-19 on the aviation sector. For the avoidance of doubt in conducting this assessment our assumption on the charges that NERL would have been entitled to recover will be the assumptions set out in the CMA's final report.
17. We note that we have said in our submissions to the CMA that, guided by our statutory duties, we will review NERL's 2020 actuals and latest forecast 2021 costs and that the review process will include consideration of what revenue correction, if any, should be applied for those years.⁷

⁷ www.caa.co.uk/cap1910A (paragraphs A24 to A26).

Views invited and next steps

Views invited

18. We invite representations on the suggested modifications to implement the CMA determination, the proposal to introduce a new Condition 10a, the minor modifications to improve clarity, draft RPS and draft guidance to economicregulation@caa.co.uk by 21 October 2020.
19. 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. 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.
20. If you have any questions on this document please contact Rod Gander at rod.gander@caa.co.uk.

Licence modifications following a reference to the CMA

21. As mentioned in paragraph 9, we will consider any representations received in accordance with this consultation and we will then make the suggested modifications, except in any cases where the CMA directs us not to make any modifications.
22. If the CMA directs us not to make any of the suggested modifications, the CMA shall publish a notice under s.16(4), inviting representations on any such modifications it proposes to make instead.

Other licence modifications

23. We will consider any representations about our proposed new Condition 10a and minor modifications to improve clarity, before deciding whether to introduce the new condition to NERL's licence or make the minor modifications.

Draft RPS and draft guidance

24. While outside of the formal statutory consultation process for licence modifications, we will consider any representations on the draft RPS and draft guidance before issuing the final RPS and final guidance. In considering the representations we will be mindful that in its final report, the CMA said both the RPS and guidance should be substantially consistent with the draft RPS and draft guidance we submitted in response to its provisional findings, other than to reflect the changes specified by the CMA on the draft guidance (or where changes are appropriate to address any issues that have not already been considered as part of the CMA's assessment).

Structure of this document

25. The structure of this consultation document is as follows:
- chapter 1 summarises the licence modifications required to implement the CMA's final report and determination;
 - chapter 2 summarises the new Condition relating to airspace modernisation requirements;
 - chapter 3 summarises some minor licence modifications to improve clarity;
 - chapter 4 summarises our guidance in relation to capex incentives;
 - appendix A sets out the revised licence conditions relating to the CMA's final report and determination;
 - appendix B sets out the new licence condition and accompanying guidance in respect of airspace modernisation;
 - appendix C sets out the minor licence modifications to improve clarity;
 - appendix D sets out our regulatory policy statement on the application of the demonstrably inefficient and/or wasteful capex incentive;
 - appendix E sets out our guidance on the application of the capex engagement incentive; and

- appendix F reproduces Condition 21 of the NERL licence as at 1 January 2019. Paragraphs 7 and 18 of the revised Condition 21 in appendix A refer to the Condition 21 of the Licence in effect on 1 January 2019 – this is reproduced for ease of reference.

Chapter 1

Licence modifications to implement the CMA's determination

- 1.1 The modifications we consider are needed to remedy or prevent the adverse effects specified in the CMA's final report are set out below. The effects of these modifications, which implement the CMA's determination, will be to achieve the outcomes set out in paragraph 3 of this document. Full versions of the modified conditions are in appendix A.

Condition 10 – Business plans, service and investment plans and periodic reports

Additional requirements to implement CMA determination

- 4(c) – Requiring NERL to send us and users quarterly updates on its service and investment plan in April and October each year.⁸
- 7 – Subjecting NERL to a financial incentive in respect of its capex efficiency. The incentive shall be based on whether any NERL's capex has been demonstrably inefficient and/or wasteful. The assessment shall be carried out following criteria in an RPS we produce. Any penalty shall be applied in the following regulatory period.
- 8 – Subjecting NERL to a financial incentive in respect of the quality of its engagement on its capex programme. The incentive shall be based on the following assessment criteria:
 - timeliness;
 - user-focus;
 - proportionality;

⁸ We propose to reorder the paragraphs in Condition 10 to make it easier to read. The paragraph numbers in this chapter refer to the numbers in the suggested new Conditions.

- optioneering;
- responsiveness; and
- mitigating/corrective actions.

The penalty shall be related to NERL's return on equity on its actual capex in the reference period.

The process we shall use to assess NERL's performance against the incentive shall be set out in guidance we publish.

- 9 – The IR's role shall be expanded to include:
 - assessing whether NERL has sufficiently explained and justified its capex in its SIPs;
 - assessing and proposing scores for NERL's engagement with users against the criteria in the engagement incentive and published guidance;
 - tracking and assessing NERL's progress in delivering its capex programme and achieving the associated benefits; and
 - reporting on the cost efficiency of NERL's capex and its implementation.

Other proposed modifications to Condition 10

- With NERL's consent we are also proposing to put back by one month the dates in paragraph 4 by which NERL has to submit SIPs and interim SIPs to 31 January and 31 July respectively. This is so that the dates relate more closely to NERL's planning and reporting processes.
- With NERL's consent we are also proposing to delete outdated requirements for NERL to produce detailed and outline technology programmes, detailed airspace programme and an outline of options for implementing lower level airspace changes in London terminal and related airspace redesign area as these relate specifically to RP2. However, we still expect NERL to provide, and report progress on, in its SIPs, a sufficiently detailed capex baseline covering its airspace and technology programmes during RP3;

Condition 21 – Control of Eurocontrol service charges

Changes to implement CMA determination⁹

- 1 - Changing the price control formula to take account of the CMA's determination. This includes adding determined costs, carry-overs from RP2 resulting from the implementation of the cost sharing mechanism and forecast total service units for 2020, 2021 and 2022.
- 2 – Adding inflation reference values for HICP for 2020, 2021 and 2022.
- 3 – Changing the inflation adjustment to apply to 2020, 2021 and 2022.
- 4 and 5 – Changing the formulae to apply to 2020, 2021 and 2022.
- 6 – Adding the C1 target values for 2020, 2021 and 2022.
- 7 – Changing the financial incentive calculations to apply to 2020, 2021 and 2022.
- 8 – Addition of C2 target values for 2020, 2021 and 2022.
- 9 – Addition of C3 target values for 2020, 2021 and 2022.
- 11 – Changing the definition of thresholds at which C3 bonuses and penalties become payable so they refer to 2020, 2021 and 2022.
- 13 and 15– Adding the total number of exemption days to 60 in 2020, 2021 and 2022.¹⁰
- 16 – Changing the flight efficiency incentive calculations so they refer to 2020, 2021 and 2022.

Other proposed modifications to Condition 21

- 1 – adding terms to return Innovation and Networks Executive Agency (INEA) funding and any unspent portion of the FAS Facilitation Fund to users;

⁹ Although the changes will provide the legal basis for NERL's charges in 2020 to be based on the CMA's determination, NERL's charges were set according to our RP3 decision. This means that NERL's charges are lower than they would be if set according to the CMA decision. The difference will be taken into account in our next price control review, as stated in paragraph 16.

¹⁰ In our RP3 decision we decided there should be 100 exemption days over the five year period. That is 20 days per year. The CMA agreed with our number of exemption days. As the CMA set a price control for three years, we are suggesting reducing the number of exemption days pro rata to 60 days over the three years.

- 15 – updating the list of exemptions from C3 and C4 capacity incentives;
- 16 – adding references to the updated flight efficiency metric calculation and annual review protocol.

Condition 21a – Control of London Approach charges

- 1 - Changing the London Approach charge control to take account of the CMA's determination. This includes adding determined costs and forecast total London Approach service units for 2020, 2021 2022, and adding an other revenues term that includes revenues collected from Biggin Hill.
- 2 – Adding inflation reference values for HICP for 2020, 2021 and 2022.
- 3 – Changing the inflation adjustment to apply to 2020, 2021 and 2022.
- 4 – Changing the formulae to apply to 2020, 2021 and 2022.
- 5 – Adding other revenues term.

Condition 22 – Oceanic charges

- 1 – Adding an explanation that the Oceanic charging area comprises two areas, Atlantic and Tango, with different charges, and that a flight will only incur one charge;
- 2 – Adding Atlantic and Tango charge formulae to implement the CMA's determination. The charges comprise of a base charge and a satellite data (ADS-B) charge, with adjustments for differences between forecast and actual inflation and traffic levels. The Tango, but not the Atlantic, ADS-B charge includes an adjustment related to differences between actual and forecast traffic in the Tango area.
- 3 – Adding HICP inflation forecasts for 2020, 2021 and 2022.
- 4 – Adding calculation of inflation adjustment term.
- 5 – Adding calculation of traffic adjustment term.
- 6 – Adding definition of Tango flight.
- 7 – Adding definition of Atlantic flight.
- 8 – Adding requirement for NERL to certify that it is operating a fully ADS-B based service to 99% of flights in the Oceanic area;

- 9 – Adding requirement for NERL to commission an independent review of whether the benefits of providing ADS-B service outweigh the costs of providing the service no later than two years and six months after certifying it is providing a full ADS-B service.

Chapter 2

New Condition 10a: Airspace modernisation

2.1 A key strategic consideration in our RP3 decision was to enable NERL to support the implementation of the UK's Airspace Modernisation Strategy (AMS),¹¹ which is intended to deliver a once in a generation upgrade to modernise critical national infrastructure and deliver a broad range of benefits to consumers, the aviation industry and local communities. We and the Department for Transport (DfT) co-sponsor airspace modernisation through setting the overall strategy and governance for the programme. More details on the AMS are in our RP3 Decision document¹² and on our website.¹³

2.2 NERL's roles in supporting the AMS include:

- to begin to develop a coordinated implementation plan for airspace changes (an airspace change masterplan) in the south of the UK; and
- to create a coordination group (the Airspace Change Organising Group (ACOG)).

In our RP3 decision we included a draft licence condition to underpin these requirements through NERL's licence.

2.3 While the context for airspace modernisation has changed as a result of Covid-19, we consider there remain benefits from an appropriately scoped strategy and programme and have retained the licence obligations. The draft licence condition (Condition 10a) sets out our expectations of NERL, to help it to understand what we and the DfT expect, and to clarify how it is accountable for delivery. The draft condition will require NERL to establish, maintain and manage ACOG, and create and maintain an airspace masterplan, in line with requirements or guidance provided by the co-sponsors and taking into account the expertise of

¹¹ [CAP 1711 UK Airspace Strategy \(December 2018\)](#)

¹² [UK RP3 Decision document, paragraphs 1.4-1.13 \(August 2019\)](#)

¹³ <https://www.caa.co.uk/Commercial-industry/Airspace/Airspace-Modernisation-Strategy/About-the-strategy/>

airport operators and views of stakeholders. It will also require NERL to prepare and submit changes to airspace design and airspace change proposals (ACPs) we instruct, and, where necessary, to assist other stakeholders with preparing and submitting ACPs.

Modifications

2.4 In our RP3 decision we proposed the following provisions in a draft of Condition 10a:

- 1 – NERL to establish, maintain and manage ACOG;
- 2 – NERL to create and maintain UK airspace change masterplan;
- 3 – Masterplan must be consistent with Airspace Modernisation Strategy, meet criteria set by CAA and DfT, comply with any requirements or guidance from DfT or CAA, and take into consideration views of stakeholders;
- 4 – masterplan to be assessed and accepted by CAA in consultation with DfT;
- 5 – NERL to make changes to masterplan as reasonably proposed by CAA;
- 6 – NERL to update masterplan as reasonably requested by CAA;
- 7 – NERL to prepare and submit to CAA ACPs related to the airspace for which it provides en-route air traffic control services;
- 8 – NERL to prepare and submit to CAA any proposal to change airspace design when instructed by the CAA;
- 9 – NERL may provide support to ACPs proposed by other bodies with agreement of CAA;
- 10 – NERL to assist sponsors with preparation and submission of airspace changes in the masterplan. NERL to keep CAA and DfT informed on progress of preparation and submission of ACPs in the masterplan;
- 11 – NERL to report to CAA progress against the masterplan by 1 November in each year and on request; and
- 12 – NERL to be responsible for other activities under the masterplan it is required to take under other legislation.

2.5 The impact of Covid-19 on traffic levels has reduced the urgency of the need for airspace modernisation, but has not removed the requirement to re-model airspace to provide the capacity to handle increase traffic levels expected in the long-term, and to provide more efficient routes and environmental improvement. This has led to some changes in the proposed Condition 10a from the draft version in our RP3 decision. These changes are:

- 2 - removing the requirement for NERL to submit the first phase of the masterplan by June 2020. This is because the sponsors of the airspace changes paused their work meaning that NERL could not coordinate the production of a masterplan by this deadline, furthermore this date is already past;
- 3b – for clarification “criteria” has been qualified as “criteria for a masterplan”; and
- 3c – the requirement for the masterplan to comply with the requirements of Airspace Masterplan iteration one (Southern UK) co-sponsor assessment guidance has been removed as this assessment document was never approved for publication and ACOG’s work has shifted the masterplan in a new direction, rendering feedback on earlier drafts less relevant.

2.6 The effects of introducing the new Condition 10a will be to set out NERL’s roles and responsibilities in supporting AMS in a formal and transparent manner.

2.7 The delay to airspace modernisation has also led to some changes in our guidance to NERL. The changes have been agreed with NERL. A full version of the proposed Condition 10a and accompanying guidance to NERL are in appendix B.

Chapter 3

Minor licence modifications to improve clarity

- 3.1 As we are modifying NERL's licence to implement the CMA's final report and introduce Condition 10a, we intend to take the opportunity to make some other minor modifications to improve clarity (in particular on the target level of gearing and the definition of finance leases as summarised below). Other changes (dealt with in appendix C) focus on correcting typos and updating references.

Target level of gearing

- 3.2 Currently, Condition 5(26)(b)(ii) requires NERL to explain any difference between expected average gearing at 31 March each year and the 'target' gearing level of 60%. However, we do not set a target gearing level for NERL, as we consider that its gearing level is a matter for it to decide, as long as it does not exceed the gearing cap level of 65%. The gearing cap was introduced to NERL's licence in December 2010 to enable it to maintain sufficient financial robustness to enable delivery of its regulatory obligations. Therefore, we intend to amend the description of 60% gearing from the 'target' level to the more neutral 'monitoring threshold' level of gearing to avoid giving the impression that we consider that NERL should be trying to achieve a gearing level of 60%.

Definition of finance leases

- 3.3 We also intend to add a definition of finance leases to Condition 5(29) to clarify their treatment in the calculation of NERL's gearing in the licence. The definition clarifies that finance lease costs that are treated as operating rather than capital costs for the purpose of setting NERL's price controls are not included in the net debt used to calculate gearing. This is the same approach that NERL uses to calculate gearing in its regulatory accounts but different from the approach used in its statutory accounts.

Chapter 4

Capex efficiency RPS and engagement incentive guidance

Introduction

- 4.1 In its provisional findings, the CMA found that NERL's capex should be subject to two financial incentives. An efficiency incentive that would formalise our approach to the assessment at each price control review of whether any capex should be disallowed from NERL's regulatory asset base (RAB), and a new incentive based on the quality of NERL's engagement with its users on its capex programme.

RPS *ex post* efficiency assessment of NERL's capex

- 4.2 On the efficiency incentive, the CMA considered that the lack of any published policy on how we would apply the incentive did not provide NERL with sufficient safeguards with respect to its application. The CMA considered that a licence condition that appropriately constrained the circumstances under which it would be reasonable for us to find that capex should be disallowed from NERL's RAB following an *ex post* efficiency review could help to address these concerns. It considered that the Demonstrably Inefficient and/or Wasteful Expenditure (DIWE) test similar to the arrangements for Northern Ireland electricity would be an appropriate test for NERL. The CMA also invited us to develop a policy statement on these matters to increase the transparency and certainty associated with the licence condition. In response, we produced a draft regulatory policy statement (RPS) taking into account the CMA's provisional findings, 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 RAB at the next price control review.

- 4.3 In its final report, the CMA welcomed our draft RPS and considered it sufficiently specified the basis upon which we would expect to apply a disallowance of capex, following an *ex post* efficiency review.¹⁴
- 4.4 We have made minor amendments to the draft RPS, so that it is a standalone document, but have not changed how we intend to assess whether any of NERL's capex is demonstrably inefficient and/or wasteful. The draft RPS is in appendix D.

Guidance on NERL capex engagement incentive

- 4.5 In its provisional findings, the CMA invited both us and NERL to submit a proposed design for a capex engagement incentive building on the CMA's initial specification, including:
- how performance should be defined; and
 - how financial penalties would be calculated.
- 4.6 We then produced draft guidance taking into account the CMA's provisional findings, along with other regulatory precedent, to set out the principles and procedure we would expect to follow in operating a financial incentive on NERL's engagement on its capex programme.
- 4.7 In its final report on the reference, the CMA said we should produce guidance that would be substantially consistent with our draft guidance, subject to us amending it to take account of the CMA's conclusions on:¹⁵
- us publishing the IR's assessment of NERL's scores against the assessment criteria;
 - removing the scope for a penalty uplift;
 - revising downwards the score at which the maximum penalty would be reached; and

¹⁴ [NATS \(En route\) Plc/CAA Regulatory Appeal – Final Report \(August 2020\)](#) – paragraph 9.137(c), pages 135-136

¹⁵ [NATS \(En route\) Plc/CAA Regulatory Appeal – Final Report \(August 2020\)](#) – paragraph 9.137(f)(g), pages 136-137

- limiting any adjustments to the guidance within RP3 to minor adjustments unless they were part of a wider review of the price control and licence.

4.8 We have made these changes and the revised draft guidance is in appendix E.

Non-statutory process

4.9 In accordance with the CMA's final report, the draft RPS for the efficiency incentive and the draft guidance for the capex efficiency incentive are referenced in the draft licence conditions. However, as both the RPS and guidance will be detailed working documents, the CMA considered that they should not be part of the licence. This means that the RPS and guidance are not subject to the statutory process required to make licence modifications. Nonetheless, we provide them here to assist stakeholders in understanding the associated licence modifications and invite views, as part of a non-statutory process, to assist with the finalising the guidance.

APPENDIX A**Modified Conditions to implement CMA final report**

Condition 10: Business Plans, Service and Investment Plans and Periodic Reports

1. The Licensee shall prepare a full business plan fulfilling the requirements of paragraph 3 of this Condition. The business plan must be consistent with any overall business plan of the Licensee but, provided that it fulfils the requirements of paragraph 3, for the avoidance of doubt need not constitute the entirety of any such overall business plan.
2. Business plans prepared under paragraph 1 shall be submitted to the CAA not less than twelve months before each Plan Renewal Date or at a later date agreed with the CAA, and shall relate to the period beginning on that Plan Renewal Date (or the period until expiry of the Licence whichever is the shorter period). Later business plans shall always supersede any earlier business plan in respect of a period which is covered by both. Business plans shall also comply with the relevant requirements for a business plan set out in Commission Implementing Regulation (EU) 2017/373 (and as amended by the Air Traffic Management (Amendment etc)(EU Exit) Regulations 2020 when the Air Traffic Management (Amendment etc)(EU Exit) Regulations 2020 come into force on IP completion day (as defined in section 39(1) of the European Union (Withdrawal Agreement) Act 2020)) and any relevant legislation and/or guidance issued by the Secretary of State arising out of or in connection with the withdrawal of the UK from the European Union.
3. The purpose of each business plan shall be to describe in detail the Licensee's plans and expectations for each of the En route Businesses and London Approach Service including its capital expenditure and operational plans, together with measures which it proposes to take to improve the efficiency and effectiveness of its operation in providing the services required by this Licence. Business plans shall include such information as is reasonably necessary to achieve this including, but not limited to, details concerning the following:
 - (a) the demands, in terms of the volumes of flights, which the Licensee forecasts that it will be required to serve in meeting its general obligation under Condition

2 together with the principal factors which it expects to determine those demands;

- (b) the standards of service that the Licensee plans to meet in serving the demands in sub-paragraph (a), including the expected levels of and variations in delays to the flights in respect of which services are provided, and other appropriate measures;
- (c) the capacities which the Licensee plans to provide in order to meet the demands in sub-paragraph (a) at the standards of service in sub-paragraph (b);
- (d) any underlying assumptions regarding airspace;
- (e) the likely level of and developments in any constraints on the volume of services which the Licensee may provide in each of the Licensed Areas and any proposed changes thereto;
- (f) the Licensee's capital expenditure plans and how these will contribute to the provision of the planned outputs;
- (g) the Licensee's plans with respect to operating and human resources and practices, operating expenditure and how these will contribute to the provision of the planned outputs; and
- (h) forecasts of the Licensee's financial results in terms of a regulatory income statement with associated cash flow statements and the effects on the regulatory asset base projection.

4. Every year the Licensee shall submit:

- (a) not later than 31 January in each year, a service and investment plan fulfilling the requirements of paragraph 5 of this Condition;

- (b) not later than 31 July in each year, an interim service and investment plan fulfilling the requirements of paragraph 5 of this Condition;
 - (c) not later than 30 April and 31 October in each year, an update to the service and investment plan; and
 - (d) with effect from 1 January 2020, not later than seven months after the end of the regulatory year, a business plan report fulfilling the requirements of paragraph 6 of this Condition which shall relate to the previous regulatory year.
5. Each service and investment plan and interim service and investment plan shall provide an update of:
- (a) the Licensee's investment plans, including its technology and airspace programmes;
 - (b) the Licensee's delivery of the investment plans, as measured against the capital expenditure programme milestones set out in the Licensee's business plan and as amended to be consistent with the price controls in Conditions 21, 21a and 22;
 - (c) material changes in the Licensee's expectations as to the level and quality of the services it will provide, the means by which the services will be provided, and the likely implications for charges to Users beyond the expiry of the period for which charges are for the time being set pursuant to the Charge Control Conditions. Service and investment plans shall include such information as is reasonably necessary to achieve this including, but not limited to, material changes in the Licensee's expectations as to its operating practices and resources.
6. Each business plan report shall provide a description of progress achieved in relation to the business plan and the latest service and investment plan or interim service and investment plan, reconciling actual performance against these plans. Each business

plan report shall also include information on the performance of the Licensee against its obligations in Condition 2(1)(a) of this Licence.

7. The Licensee shall be subject to a financial incentive in respect of the efficiency of its capital expenditure programme. The financial incentive shall be based on whether the Licensee has incurred any demonstrably inefficient and/or wasteful capital expenditure and shall be carried out following the criteria set out in a Regulatory Policy Statement produced by the CAA. Any penalty shall be calculated using the principles set out in the Regulatory Policy Statement and will be applied in the next reference period.
8. The Licensee shall be subject to a financial incentive in respect of the quality of its engagement on its capital expenditure programme. The incentive shall be based on the following assessment criteria:
 - (a) the timeliness of information the Licensee provides to Users, including the provision of early warning and explanation of factors that may put planned delivery timelines at risk;
 - (b) the information and mechanism of delivery is focused on the priorities and resource constraints of Users so that it is clear and accessible;
 - (c) the proportionality of the information to the materiality of change under consideration;
 - (d) the range of reasonable options that the Licensee engages on with Users that might be adopted where practical and opportunities provided for engagement and scrutiny of those options;
 - (e) the Licensee's responsiveness to User and Independent Reviewer submissions including the clear explanation of how it has considered and taken account of those submissions; and
 - (f) whether the Licensee has taken the appropriate mitigation and corrective actions in the light of User and Independent Reviewer submissions.

The maximum value of any penalty with respect of the quality NERL's engagement on its capital expenditure programme in a reference period shall be limited to the Licensee's return on equity on its actual capital expenditure in the reference period and shall be applied in the next reference period.

The process that the CAA shall use to assess the Licensee's performance against the engagement incentive and determine the level of penalty (if any) to be applied shall be set out in a guidance document published by the CAA.

9. The CAA may appoint an Independent Reviewer to report on the Licensee's delivery of and engagement on its capital expenditure programme. The reports shall:
- a) review the timeliness and accuracy of the Licensee's reporting in its service and investment plans;
 - b) assess whether the Licensee has sufficiently explained and justified its capital expenditure programme in its service and investment plans;
 - c) assess and propose scores for the Licensee's engagement with Users against the assessment criteria referred in paragraph 8 and the CAA's published guidance;
 - d) track and assess the Licensee's progress on delivering its capital expenditure programme and achieving the associated benefits; and
 - e) report on the cost efficiency of the Licensee's capital expenditure and its implementation.

The CAA may publish the reviews, assessments and reports of the Independent Reviewer. Unless the CAA directs otherwise, the Independent Reviewer will be paid for by the Licensee.

10. The form, scope and level of detail of the Licensee's plans referred to in this Condition shall be as reasonably approved by the CAA and shall take into account the views of Users consulted in accordance with Condition 16.
11. Subject to paragraph 12, the Licensee shall make available a copy of the latest business plan, business plan report, service and investment plan and interim service and investment plan to any person who requests a copy of such plan or report.
12. The Licensee may with the prior consent of the CAA (provided that such consent is not unreasonably withheld or delayed) omit from any document made available under