

Economic regulation of NATS (En Route) plc: consultation on approach to the next price controls review

CAP 1994

Published by the Civil Aviation Authority, 2020

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First published 2020

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About this document

This document sets out the key issues and seeks stakeholder views on the approach to the economic regulation of NATS (En Route) plc (NERL) in light of the impact of the Covid-19 pandemic. The Competition and Market Authority's (CMA) report and determination, following the proposals of the CAA, established price controls for NERL for the period 2020 to 2022. However, in light of the Covid-19 pandemic, the CMA agreed that the CAA should review the regulatory arrangements once there was better information about the path to recovery from the pandemic. This document provides our initial views and proposes next steps for consultation.

The document sets out:

- the short-term and longer-term policy challenges that we will need to address in developing the regulatory framework for NERL;
- policy options for addressing these challenges; and
- the timetable and processes we will need to follow to have new price controls in place in a timely manner.

Views invited

We welcome views on all the issues raised in this document and, in particular, the questions highlighted in chapters 1 to 3 and Appendices C and D.

Please e-mail responses to economicregulation@caa.co.uk by no later than 12 January 2021. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for 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 Transport Act 2000 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Matt Claydon (matt.claydon@caa.co.uk).

Summary and introduction

Introduction

1. NERL¹ is subject to price controls that set the maximum charges that it can recover from airspace users for the provision of air traffic services (ATS) for its Eurocontrol en route, London Approach and Oceanic en route services.
2. We last made price control determinations on NERL's charges for Reference Period 3 (RP3) in 2019, which were intended to cover the period from 2020 until 2024. In making our RP3 decisions, as well as setting maximum charges, service quality targets and incentives, we also introduced enhanced capital expenditure (capex) governance arrangements and incentives. We also set out roles for NERL in supporting the Airspace Change Organising Group (ACOG) and creation of an airspace design masterplan for the UK.
3. NERL rejected our RP3 decisions and the determination was referred to the Competition and Markets Authority (CMA) to resolve. During the period when the CMA was considering the reference, Covid-19 emerged as a global pandemic, with the resulting severe and unprecedented downturn across the aviation sector. Air traffic volumes in April 2020 were approximately 90% below April 2019 volumes. There has been a modest, but variable recovery since then. In August 2020, flights were approximately 60% lower than the previous year, however by October 2020 this had fallen to approximately 65% lower than the previous year.² Recent developments with vaccines provide stronger prospects for recovery in 2021, but there remains a significant degree of uncertainty about how any recovery will develop.
4. In reviewing our RP3 decisions early in 2020, the CMA decided that the impact of Covid-19 would be too difficult to properly assess as part of its determination and that we should review these matters when better information was available.

¹ Abbreviations used in this consultation as well as references to previous CAA consultations are set out in Appendix A.

² Source: Network Manager, Eurocontrol.

The CMA established price controls covering the period January 2020 to December 2022, on the expectation that this would give the CAA enough time to set new controls and take into account a greater understanding of the impact of the Covid-19 pandemic and the path of recovery, but the CMA was clear that the CAA should bring forward new price controls sooner if appropriate. The CMA also set out an expectation that a reconciliation exercise would be necessary for 2020 and 2021 with reference to actual flight volumes and costs over the period since the start of 2020. The CMA made its final report in July 2020 and, subject to the statutory process, we expect the associated licence modifications to be in force before the end of 2020.³

5. Overall, the CMA determination made a number of changes to NERL's capital expenditure incentives and allowed NERL about a further £34 million over the period 2020 to 2022, which represents a 1.8% increase compared to our original decisions, in respect of the main en route price control.⁴ The majority of the difference relates to an additional £14 million in respect of non-regulated income and an increase in the pre-tax weighted cost of capital (WACC) allowance from 2.91% to 3.48%, worth about £19 million.

Key issues

6. Our approach to the regulation of NERL will continue to be driven by our duties under the Transport Act 2000 ("TA00"). Consistent with our primary duty, our overriding priority will be to take the steps necessary to support NERL in maintaining a high standard of safety in the provision of ATS. We must also exercise our ATS functions in a manner we think are best calculated to protect and further consumers' interests, and promote economy and efficiency on the part of NERL – for ease, we sometimes refer to these duties collectively as "affordability and protecting consumers' interests" in this consultation. Our duties also require that we secure that NERL does not find it unduly difficult to finance

³ See the CAA's CAP1967 consultation on proposed modifications to NERL's licence conditions, Sept 2020:
[http://publicapps.caa.co.uk/docs/33/Economic%20regulation%20of%20NATS%20\(En%20Route\)%20plc%20\(CAP1967\).pdf](http://publicapps.caa.co.uk/docs/33/Economic%20regulation%20of%20NATS%20(En%20Route)%20plc%20(CAP1967).pdf)

⁴ Based on data in Table F1, [Appendix F](#). CMA final report on NATS (En Route) Plc/CAA Regulatory Appeal.

its licensed activities as set out in the TA00. Appendix B of this consultation sets out our duties in full.

7. We emphasise affordability to recognise that part of the interests of users are served by NERL's charges being at a level that supports users in re-establishing and operating services, given the difficult circumstances created by Covid-19. Beyond this broad concept we have not yet crystallised a clear definition of affordability, but it seems unlikely in the difficult circumstances of Covid-19 we will be able to rely on a simple definition of affordability (such as no real increase in charges), and would welcome the views of stakeholders on these matters. Although the services provided by NERL are often not a large proportion of the costs of operating a flight, it is recognised its charges contribute to a cumulative impact on the viability of different routes and the choices available to passengers.
8. We will need to deal, in the best way practicable, with the severe impact of Covid-19 on the sector and the particularly uncertain path of its recovery. This will influence all the main aspects of our work on the regulatory framework for NERL, which will need to address the following two main sets of challenges:
 - a) Adapting the current regulatory framework to take account of the impact of Covid-19 on the sector in 2020-2021. In doing so we will need to take account of any acute short-term issues (including possible issues relating to NERL's financeability); develop an approach to the reconciliation of traffic risk sharing (TRS) arrangements and deal with issues around the regulatory treatment of pension costs. Our approach to these matters should also allow for an appropriate transition to the regulatory arrangements that we will put in place for the next regulatory period (i.e. from 2022).
 - b) Developing the future regulatory framework from 2022. We will need to develop future regulatory framework and price control arrangements in a way that is flexible to uncertainty about future costs and the speed of traffic recovery, while also supporting both the financeability of NERL and the affordability of its charges to users (in line with our statutory duties).
9. These challenges are discussed further in chapter 1.

Policy options – key themes

10. To address these challenges, we need to develop a coherent set of regulatory arrangements. The inter-relatedness of approaches and measures to address these issues in both the short and long-term, will mean it will be necessary to take a holistic view on the most appropriate way forward. Given the challenges that the sector faces, we cannot assume it will be appropriate to simply roll forward all the previous regulatory arrangements without modification. But we will look to build on the existing arrangements where appropriate so that they properly support NERL's longer-term financeability and the affordability of its charges.
11. To ensure users benefit from better and lower cost services, we want to ensure NERL has appropriate incentives for efficiency, while also protecting the quality of service. Appropriate efficiency incentives can help to maintain affordable charges for users in 2022 (when the sector is likely to be continuing to recover from the impact of Covid-19) and beyond. In addition, given the unprecedented impact of Covid-19 on the sector we will need to consider whether it is appropriate to take further steps to protect affordability, such as recovering the revenue associated with the 2020 and 2021 reconciliation over an extended period.
12. Traffic volume related risks will persist beyond 2021. We therefore need to deal with uncertainty including how best to calibrate risk-sharing for the period from 2022. Key issues include the basic calibration of risk-sharing arrangements, including understanding how costs vary with traffic levels, and the mechanisms for the reconciliation of these arrangements.
13. In considering efficiency and affordability, we need to proceed carefully so that we do not create undue risks for NERL that could lead to increases in the cost of capital, which in turn would feed into higher prices for users. It will also be important to deal with short-term issues around affordability and financeability while ensuring the longer-term interests of consumers are properly considered. For example, although in the short-term there may be scope for NERL to reasonably defer some capital spending, it is likely to be in consumers' long-term interests for NERL to invest in programmes such as airspace modernisation.

Hence, it is important the regulatory framework supports NERL's financeability and capacity to invest in the longer-term.

14. The pension costs that are passed through to regulated charges will also need to continue to be reasonable and affordable, and NERL may need the support of its pension trustees to achieve these objectives. To support the development of an appropriate approach to these matters, we are consulting on a draft regulatory policy statement (RPS) on pension costs, as set out in Appendix C.
15. In making decisions all on these matters, we will need to consider the advantages of consistency with the existing regulatory arrangements and how to protect users and have regard to NERL's financeability. However, where other more conventional measures are unable to deliver affordable user charges that support the recovery of the industry in the face of the exceptional circumstances caused by Covid-19 and the ongoing risks of very low aviation traffic volumes, we may need to consider wider measures. In those circumstances, we cannot at this stage rule out NERL's providers of equity finance needing to provide additional support, so that its charges remain affordable and its business financeable. This would require careful assessment of the overall regulatory arrangements, to protect the long-term financeability of NERL's activities and support its access to cost efficient investment grade debt finance.
16. These matters are discussed further in chapter 2, and our approach is summarised in paragraphs 2.14 to 2.16.

Process and timetable issues

17. In chapter 3, we highlight important process issues, including:
 - NERL's request that we provide confirmation on our approach to TRS, to support a refinancing of its bank facilities in 2021;
 - the duration of the next main price controls and our present view that, if it is practicable, we should set a five-year price control;
 - the timetable for the price controls review and arrangements for NERL's next business plan; and
 - how to ensure effective customer engagement.

Next steps and views invited

18. Views are invited in the matters discussed in this consultation by 12 January 2021.
19. We will consider the views of respondents and any further evidence that is provided carefully and will issue a further statement of these matters no later than February 2021.
20. Our work on NERL's next main price controls review will continue throughout 2021.

Key issues for consultation

21. Views are invited on any of the issues raised in this document and, in particular:
 - the short-term challenges around the reconciliation of TRS arrangements for 2020 and 2021, pension costs and financeability;
 - the longer-term challenges around maintaining the affordability of charges and financeability – and how best to deal with uncertainty, identify efficient costs, provide incentives for cost efficiency and develop arrangements that support a longer-term sustainable financial position for NERL with a cost of capital that is no higher than is necessary;
 - the issues relating to the policy options for the next price controls review and our initial thinking on these matters, as summarised in chapter 2. It will be particularly important to hear from users about their priorities and how we might best assess the affordability of NERL's charges;
 - the issues around the timing and duration of the next price controls, including whether we should seek to complete our substantive work on the price control review in 2021 or take longer and put interim arrangements in place for 2022;
 - the timetable for the price control reviews and processes for stakeholder engagement;
 - the draft regulatory policy statement in relation to pension costs, set out in Appendix C; and
 - the approach to the 2020/2021 reconciliation of revenues/cost as discussed in Appendix D.

Our duties and the regulatory framework

22. In developing this consultation, we have had full regard to our statutory duties under the TA00, which are set out in Appendix B.

Regulatory framework

UK/EU transition

23. NERL has been subject to an economic regulatory framework under the TA00 and its licence since its privatisation in 2001. Since 2012, it has also been subject to the EU Single European Sky (SES) performance scheme for air navigation services (ANS). The performance scheme is established under EU regulations, which have direct effect in the UK until the end of the EU exit implementation period on 31 December 2020.
24. Currently, it is not expected that any UK/EU transition arrangements will cover economic regulation of ANS and it is expected that as of 1 January 2021, the economic regulation of NERL will revert to being solely under the framework provided by the TA00 and NERL's licence.⁵ This consultation document has been developed on this basis.

ATM and UA Bill

25. Proposed amendments to some aspects of the licensing regime for the economic regulation of ATS set out in the TA00, are currently being considered under the Air Traffic Management and Unmanned Aircraft (ATM and UA) Bill, which is progressing through parliament.⁶ Part 2 of the ATM and UA Bill focuses on ATS and intends to update the regulatory framework governing the provision of ATS. It will repeal and replace the current provisions covering licence modification and enforcement in Part 1 of the TA00. The proposed provisions contain a more comprehensive suite of regulatory and enforcement tools, including a new procedure for modifying licence conditions. There will also be new rights for NERL (as the licence holder), airspace users and airports whose interests are materially affected, to appeal licence modification decisions to the CMA. Additionally, the ATM and UA Bill includes provision for enforcement in respect of a breach of a condition or statutory duty.

⁵ Eurocontrol provides a Central Route Charges Office, which manages the collection of unit rates on behalf of its member states. Underpinning this are the Eurocontrol 'Principles for establishing the cost-base for en route charges and the calculation of unit rates'. As appropriate, our domestic framework for the regulation of NERL will take into account the UK's obligations as a member of Eurocontrol.

⁶ [Air Traffic Management and Unmanned Aircraft Bill \[HL\] 2019-21](#)

26. The process issues addressed in chapter 3 of this document, include the modification of the NERL licence to implement new price controls. This document has been developed on the basis of the current licence modification process provided for in the TA00. If the Parliamentary process for the ATM and UA Bill concludes and its requirements come into force, we will update our process and timetable as appropriate.

Structure of this document

27. The structure of this consultation document is as follows:
- chapter 1 sets out the key challenges for our review of NERL's price control arrangements;
 - chapter 2 considers the policy options to address the key challenges;
 - chapter 3 sets out process issues associated with the timetable for the review and provides an update on our planned review of Oceanic space-based ADS-B; and
 - the appendices set out a draft RPS on pension costs, our initial thinking on the approach to the 2020 and 2021 reconciliation review, as well as providing information on our duties and a guide to the abbreviations used in this document.

Chapter 1

Challenges for the review

Introduction

- 1.1 This chapter sets out the key challenges as we approach our next review of NERL's price control arrangements. The severe impact of Covid-19 on the sector and the highly uncertain path of the recovery will affect all aspects of this work.
- 1.2 The challenges relate to the short-term (2020 and 2021) and to the next regulatory period (from 2022).
- **Responding to issues for 2020 and 2021** – the current regulatory arrangements, determined by the CMA review to apply from 2020, were established without taking account of the impact of Covid-19 on the sector. As part of the CMA's review process, we committed to carry out a reconciliation and review to take account of Covid-19. Our review will consider any acute short-term issues (including any issues that relate to short-term impacts on user charges or NERL's financeability), as well as seeking to ensure an appropriate transition to the regulatory arrangements that we will put in place for the next regulatory period.
 - **Responding to issues for the new price controls from 2022** – we will also need to establish a future regulatory framework and price control arrangements that allow for both NERL's longer-term financeability and the affordability of its charges for users. This will involve:
 - dealing with uncertainty around traffic volumes;
 - identifying efficient levels of costs;
 - developing effective incentives; and
 - setting an appropriate cost of capital.
- 1.3 We discuss these challenges in turn below.

Responding to issues for 2020 and 2021

- 1.4 For 2020 and 2021, the sector is facing challenges in the near-term around:

- **Traffic risk-sharing and reconciliation** – we expect NERL will see a significant reduction in revenue in 2020 and 2021 compared with forecasts in the CMA's review for RP3. The current mechanism in NERL's licence would allow a significant proportion of the under-recovery in 2020 to be recovered in 2022, leading to a significant increase in user charges. For the 2020 and 2021 reconciliation, we will need to consider the efficient level of NERL's costs in light of lower traffic levels, and consider how traffic risk-sharing can be reasonably adapted to support recovery in the sector and affordability of user charges;
- **Financeability** – there is uncertainty regarding the recovery in traffic that could potentially create financeability challenges for NERL. Alongside this, in 2021 NERL intends to refinance arrangements it currently has in place for its bank facilities. In addition to appropriate actions being taken by NERL, we will need to consider our approach to developing the regulatory framework for NERL in a way that supports efficient and appropriate financing; and
- **Pension costs** – the next triennial valuation date for NERL's defined benefit pension scheme is 31 December 2020. How we propose to regulate NERL, including the treatment of its pension costs, will inform the NERL pension trustees' views and discussions with NERL on the future level and timing of NERL's pension contributions. Consistent with the CMA's final determination we are consulting on the development of a regulatory policy statement (RPS) on pension costs.

Traffic risk-sharing and reconciliation

- 1.5 The current traffic risk-sharing (TRS) mechanism provides for NERL to bear up to 4.4% of the risk around higher or lower than expected traffic levels, with revenue adjustments made with a two-year lag. In the current circumstances, the TRS arrangements would not seem to protect or further the interests of users. For example, NERL would be set to recover an additional £420 million in 2022 (based on current traffic forecasts for 2020 that are around one-third of the forecasts for 2020 in the CMA's final decision). If traffic is still below baseline levels in 2022, this could lead to user charges roughly doubling compared with the pre-Covid baseline in 2022. Even if traffic levels increased more quickly in 2021 and 2022, there would still be a significant increase in user charges at a time when the sector is recovering, and large increases may be unaffordable for airspace users in the short-term.
- 1.6 These TRS arrangements were put in place pursuant to the EU performance scheme. We do not expect the UK to be subject to the EU performance scheme from 2021. Nevertheless, the approach taken by the European Commission provides a relevant reference point as EU Member States face similar challenges to the UK, to balance the interests of users and air navigation service providers (ANSPs).