

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

CAP 2119

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About this document

This document provides an update on our approach to the next NATS (En Route) plc (NERL) price control, following our December 2020 consultation (CAP1994) on these matters.

This document builds on the previous consultation in providing more clarity about the CAA's approach to the next NERL price control review. In particular, this document aims to provide a direction of travel on the following issues:

- our approach to Traffic Risk Sharing (TRS) policy and 2020 and 2021 reconciliation exercise, together with our latest position for start date for the next price control (which we now intend to be January 2023);
- the high-level framework for the next price control review;
- pensions policy including the Pensions regulatory policy statement (RPS); and
- our current thinking on timetable and process issues for the next stages of our work.

Next steps

Any responses to this consultation should be provided by 15 April 2021. We intend to update on our timetable before the end of May 2021 and publish a working paper on the reconciliation exercise by the end of June 2021.

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

Summary and introduction

Background

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 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 the 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 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 very modest, and variable, recovery since then. In August 2020, flights were approximately 60% lower than the previous year. By February 2021 this has fallen to approximately 79% lower than February 2019.² While there are stronger prospects for recovery in 2021, given the vaccination programmes now starting in many countries, there remains a significant degree of uncertainty about how recovery will develop. While the UK nations have set out their timetable for lockdown easing, including developing a roadmap towards resuming international travel on a large scale, the pace with which this travel will resume will also depend on the progress made internationally.
4. In reviewing our RP3 decisions early in 2020, the CMA decided that the impact of Covid-19 would be too difficult to assess properly as part of its determination and that we should review these matters when better information was available. 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 price controls and better take into account the impact of the Covid-19

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.

pandemic and the path of recovery. 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 2020.³

5. Overall, the CMA determination made a number of changes to NERL's capex incentives and allowed NERL a further approximately £34 million of revenue 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 increase relates to the CMA's decision not to reduce NERL's operating cost allowances in line with expected reductions in non-regulated revenue and an increase in the pre-tax weighted cost of capital (WACC) allowance from 2.91% to 3.48%.

December 2020 consultation

6. In December 2020, we published a consultation document (CAP1994) which set out our initial thinking on the key issues regarding our approach to the next NERL price controls in light of the impact of the Covid-19 pandemic. It addressed:
 - the short-term and longer-term policy challenges that we will need to consider in developing the regulatory framework for NERL;
 - policy options for addressing these challenges; and
 - the timetable and processes which we will need to follow in order to have new price controls in place in a timely manner.
7. In relation to the short-term, we said that we would adapt the current regulatory framework to take account of the impact of Covid-19 on the sector in 2020-2021. In doing so we would need to carry out a reconciliation of TRS arrangements and deal with issues around the regulatory treatment of pension costs. We would also need to take into account any acute short-term issues (including possible issues relating to NERL's financeability). We also said that our approach to these matters should allow for an appropriate transition to the regulatory arrangements that we will put in place for the next regulatory period.
8. With respect to the longer-term issues, we said that we would develop the future regulatory framework and price control arrangements from 2022 in a way that is flexible to uncertainty about future costs and the speed of traffic recovery, while

³ See the CAA's CAP1967 consultation on proposed modifications to NERL's licence conditions, Sept 2020: <https://www.caa.co.uk/cap1967>

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

also supporting both the affordability of NERL's charges to users and its financeability (in line with our statutory duties).

9. We noted that the interests of users would be 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. However, we said that beyond this broad concept we have not yet crystallised a clear definition of affordability, and that in the difficult circumstances of Covid-19 it seems unlikely that 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.
10. We also put forward a range of policy options designed to address the challenges we had identified and noted that stakeholders should not assume it will be appropriate to simply roll forward all the previous regulatory arrangements without modification. We said we would look to build on the existing arrangements where appropriate so that they properly support the affordability of NERL's charges and its longer-term financeability. More specifically, we said that we would seek to:
 - protect affordability by ensuring that NERL has appropriate incentives for efficiency, while also protecting the quality of service;
 - consider whether it is appropriate to take further steps such as recovering the revenue associated with the 2020 and 2021 reconciliation over an extended period;
 - address continued uncertainty regarding traffic volumes including how best to calibrate risk-sharing for the period from 2022;
 - 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;
 - deal with short-term issues around affordability and financeability while ensuring the longer-term interests of consumers are properly considered;
 - ensure that the pension costs that are passed through to regulated charges will continue to be reasonable and affordable; and
 - not rule out NERL's providers of equity finance needing to provide additional support, to support both affordable charges and its business remaining financeable.
11. The December 2020 consultation also highlighted important process and timetable issues, including:
 - NERL's request that we provide confirmation on our approach to the TRS reconciliation, to support a refinancing of its bank facilities in 2021;

- the duration of the next main price controls and our 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.

Summary of this document

12. This document provides an update on our thinking in respect of the challenges and policy options which we identified in the December 2020 consultation and explains how we have responded to the views set out in the consultation responses. In particular, this document aims to provide a direction of travel on the following price control issues:
 - approach to Traffic Risk Sharing (TRS) policy and 2020 and 2021 reconciliation exercise, together with our latest position for the start date for the next price control (which we now intend to be January 2023);
 - the high-level framework for the next price control review;
 - pensions policy including the Pensions RPS; and
 - our current thinking on timetable and process issues for the next stages of our work.
13. This update focuses on stakeholder responses in relation to the subjects above. It does not cover in detail all the policy areas touched on in the December 2020 consultation or subsequent representations, such as service quality performance and incentives, investment programme (including Airspace Modernisation Strategy), business plan guidance and review of Oceanic Automatic Dependent Surveillance-Broadcast (ADS-B). These will be considered in due course.
14. Overall, we intend to continue with the broad approach set out in December 2020, including in respect of the reconciliation of TRS arrangements. The main development in our policy and approach is that we intend now to rely on the price control arrangements put in place by the CMA for 2022 and defer the start of the next main price control period and the recovery of revenue from the reconciliation exercise to the five-year period starting in 2023. This will protect the affordability of charges in 2022, should support NERL's financeability in 2022 and is consistent with the views of respondents to the December 2020 consultation. We consider that taking more time to set a price control starting in 2023, rather than 2022, will provide a better opportunity to set a longer-term price control given there should be better information, and the potential for more certainty, about the likely path of traffic volumes and costs.

15. Nonetheless, there will be remaining uncertainties around traffic volumes and NERL's costs by starting the price control in 2023. As a number of respondents to the December 2020 consultation have noted, there may be a tension between affordability and financeability, particularly as by starting the new control period in 2023 we will create the need for an additional year of reconciliation. Specifically, this reconciliation will have the effect of pushing out the recovery of costs into the future – meaning that there may be more pressure on affordability and financeability. To the extent it is practicable we will seek to address any such difficulties by using conventional regulatory levers, such as spreading the recovery of revenue over a greater period of time, but as we noted in the December 2020 consultation, given the ongoing uncertainty, we cannot at this stage rule out setting price control arrangements on the basis that NERL's shareholders provide additional support to its regulated business. However, we note there has been positive progress since that consultation with regards to developing a roadmap to resume international travel at scale, alongside positive steps that NERL has made in respect of its overall refinancing, which has the potential to allow NERL to better support affordable charges and the recovery of the sector.
16. NERL has significant pension liabilities, in particular in relation to its defined benefit pension scheme. It has taken steps to mitigate these costs, including closing the scheme to new joiners in 2009. However, the scheme has strong legal protections and NERL's obligations remain a significant part of its costs base. We consulted on a draft RPS in the December 2020 consultation to provide further clarity to NERL and its pension trustee on the regulatory treatment of pensions. We expect this to provide benefits to consumers in the long-term by reducing uncertainty and the expected costs of NERL's pension liabilities. Respondents to the December 2020 consultation broadly supported a RPS and we discuss further in chapter 2 the approach we have taken to finalising the Pensions RPS (which is set out in Appendix C).
17. Delaying the new price controls until 2023 will allow more time to consider emerging traffic forecasts and the shape of industry recovery, and the development of credible and robust business plans for the forthcoming regulatory period. It is also expected that new statutory provisions introduced by the Air Traffic Management and Unmanned Aircraft (ATM and UA) Bill will change the licence modification process and appeal rights, which will need to be factored into the forward review timetable. We discuss the timetable for the review in chapter 3 and will engage with stakeholders further on these matters.
18. Our plans for further deliverables during 2021 include an update on the timetable and a working paper on our approach to the 2020 and 2021 reconciliation review. This working paper will focus primarily on TRS, but we will also consider whether we should make changes to compensate for any incentive arrangements that might produce significant and perverse outcomes in the

circumstances of Covid-19. Later in 2021 we will consult on the necessary licence modifications (and any appropriate consequential changes) to prevent the automatic operation of the TRS mechanism for under recoveries from 2020 in the 2022 unit rate, and set out the principles that will allow the recovery of these revenues in the future.

Our duties and the regulatory framework

19. In developing this consultation, we have had full regard to our statutory duties under the Transport Act 2000 (TA00), which are set out in Appendix B.

Wider statutory framework

UK/EU transition

20. NERL has been subject to an economic regulatory framework under the TA00 and its licence since its privatisation in 2001. Since 2012, it had 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 no longer apply in the UK. As of 1 January 2021, the economic regulation of NERL reverted to being solely under the framework provided by the TA00 and NERL's licence.
21. Our TA00 obligations include taking into account, as appropriate, requirements on the UK as a member of Eurocontrol,⁵ including a common policy on en route charges as set out in the Eurocontrol Charging Principles.⁶

ATM and UA Bill

22. Proposed amendments to aspects of the licensing regime for the economic regulation of ATS in the TA00, are currently being considered under the ATM and UA Bill, which is progressing through Parliament.⁷ Part 2 of the ATM and UA Bill focuses on ATS and updates the licensing framework for economic regulation that governs the provision of ATS. It will modernise the current licence modification and enforcement provisions in Part 1 of the TA00, in line with best regulatory practice. The proposed provisions contain a more comprehensive suite of regulatory and enforcement tools, including a new procedure for the CAA to modify licence conditions and a new power for the Secretary of State to amend terms of the licence. 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

⁵ Eurocontrol provides a Central Route Charges Office, which manages the collection of unit rates on behalf of its member states.

⁶ [Principles for establishing the cost-base for en route charges and the calculation of unit rates.](#)

⁷ [Air Traffic Management and Unmanned Aircraft Bill \[HL\] 2019-21](#)

licence condition or statutory duty, which NERL can appeal to the Competition Appeals Tribunal (CAT).

Views invited

23. The primary purpose of this document is to update stakeholders on our policy position for the next main price control review, which we now intend to carry out over the remainder of 2021 and 2022, with new arrangements implemented from January 2023.
24. If stakeholders have any comments on the material set out in this consultation or any associated issues then they should send these to economicregulation@caa.co.uk no later than 15 April 2021.

Structure of this document

25. The structure of this document is as set out below.
- Chapter 1 sets out our updated thinking on the TRS arrangements and 2020/21 reconciliation, together with that on the start date and duration of the next price control. It also covers our updated thinking on the framework for our approach to the next NERL price control more generally.
 - Chapter 2 sets out our final policy position on the RPS for Defined Benefit pensions costs.
 - Chapter 3 sets out our updated thinking on the timetable and process issues including deliverables for the next NERL price control.
26. The appendices provide the Pensions RPS as well as providing information on our duties and a guide to the abbreviations used in this document.

Chapter 1

Reconciliation of TRS arrangements and next price control review

Introduction

- 1.1 This chapter summarises the responses we received to the December 2020 consultation, and sets out our updated thinking on:
- the TRS arrangements and reconciliation for 2020 and 2021;
 - the start date and duration of the next price control; and
 - our broad approach to developing the regulatory framework for NERL during the next price control review.

Reconciliation of TRS arrangements for 2020 and 2021

- 1.2 The December 2020 consultation said that we would need to carry out a reconciliation of the TRS arrangements for 2020 and 2021 and integrate the recovery of an appropriate level of revenue in our proposals for the next price control. We said that we expected the new price control to commence in 2022 and, if practicable to set on this basis, have a five-year price control.
- 1.3 Respondents generally supported our intention to revisit the TRS mechanism to avoid a steep increase in charges which could be unaffordable. However, there were different views on the extent to which some, or all, of the shortfall in revenues should be met by the amended TRS arrangements or a combination of TRS, Government and shareholders. Many respondents questioned whether it was reasonable for the amended TRS arrangements to allow for the recovery of all costs from users. Some suggested that some, or all, of any shortfall in revenue should instead be met by a combination of the Government and shareholders.
- 1.4 Some respondents provided more detailed views on the range of possible options for approaching this reconciliation exercise. Further details of responses are provided below.

Airspace users

- 1.5 There was general support from airspace users and IATA for amending the TRS mechanism by adopting a similar approach to the European Commission (EC), which involves establishing new cost baselines and extending the recovery period. However, users also wanted to avoid a steep increase in charges that might occur with the recovery of TRS revenue from 2022. Some users suggested