

# Economic regulation of NATS (En Route) plc: further update on approach to the next price control review (“NR23”)

CAP2160

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## About this document

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This document follows on from the December 2020 Consultation (CAP1944) and March 2021 Update (CAP2119) publications and provides further details on the next NERL price control review (“NR23”), including:

- our current view on the timetable;
- guidance for NERL in developing its business plan and the engagement process with stakeholders; and
- our intended approach to the reconciliation of NERL’s revenues for 2020 to 2022.

This document has been informed by the representations received in response to the March 2021 Update.

## Next steps

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In chapter 3, we request feedback on our policy on the reconciliation review. Please e-mail responses to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) by no later than 15 July 2021.

The rest of this document is intended to provide guidance to NERL and other stakeholders. Comments are also welcome on these matters.

If you would like to discuss any aspect of this document, please contact Stewart Carter ([stewart.carter@caa.co.uk](mailto:stewart.carter@caa.co.uk)).

# Summary and introduction

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## Introduction

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1. This document follows on from the December 2020 Consultation (CAP1944) and March 2021 Update (CAP2119) publications and provides further details in relation to the next NERL price control review ("NR23"), including:
  - our current view on the timetable (see chapter 1);
  - guidance for NERL in developing its business plan and the customer engagement process with airspace users (see chapter 2); and
  - the reconciliation review for NERL's revenues for 2020 to 2022 (see chapter 3).<sup>1</sup>
2. We have considered the representations that we received to the March 2021 Update on the issues above.
3. In chapter 3 we request feedback on our policy for the reconciliation review. The rest of this document is intended to provide updates and guidance to NERL and other stakeholders.

## Background on previous documents

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4. NERL 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.
5. We last made price control determinations on NERL's charges for Reference Period 3 ("RP3") in 2019. NERL rejected our RP3 decisions and the determination was referred to the Competition and Markets Authority ("CMA"). 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. The CMA decided that due to the uncertainty created by covid-19, we should review the price control to take account of the impact of the covid-19 pandemic when better information had become available. The CMA established price controls covering the period January 2020 to December 2022. The CMA said a reconciliation review would be

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<sup>1</sup> In our March 2021 Update, we said that we would publish a working paper on the 2020 to 2022 reconciliation by the end of June 2021. This material has been incorporated into chapter 3 of this document.

appropriate with reference to actual flight volumes and costs over the period since the start of 2020.

6. In December 2020, we published a consultation which set out our initial thinking on the key issues regarding our approach to the next price control for NERL in the light of the impact of the covid-19 pandemic. It identified:
  - the short-term and longer-term policy challenges that we would need to consider in developing the regulatory framework for NERL;
  - the possible policy options for addressing these challenges; and
  - the timetable and processes which we would need to follow in order to have new price controls in place in a timely manner.
7. In March 2021, we published an update which set out our thinking on our overall approach to policy, the timetable, process issues, and our approach to Traffic Risk Sharing (“TRS”) and the reconciliation review. It also included the Pensions regulatory policy statement.

## Update on timetable for NR23

8. In the March 2021 Update, we said that we intend 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 to January 2023. We understand that stakeholders broadly support this approach.
9. We also said that NERL should aim to deliver its business plan to us by the end of 2021, and we would engage with stakeholders to develop a provisional timetable and publish an update as soon as practicable. In response, NERL suggested that we move the date for its business plan to March 2022 and a number of other stakeholders asked that we set out a clear timetable as a priority.
10. The continuing uncertainty around the recovery of air traffic levels from the impact of the covid-19 pandemic means that we may need to be particularly flexible with the timetable for this review to suit evolving circumstances. Our current view of the timetable is summarised below:

|                         |                                                 |
|-------------------------|-------------------------------------------------|
| <b>10 December 2021</b> | NERL to provide a building block update         |
| <b>7 February 2022</b>  | NERL to provide its business plan               |
| <b>June 2022</b>        | CAA publishes its Initial Proposals             |
| <b>November 2022</b>    | CAA publishes its Final Decisions               |
| <b>January 2023</b>     | CAA publishes its licence modification decision |

11. While we are allowing NERL more time to produce its business plan we do not agree that NERL should delay providing its business plan to March 2022, as this would not allow sufficient time for us to reach a decision and consult on price control proposals and licence modifications. We recognise that the timetable remains tight. To mitigate these risks we have proposed a more iterative process whereby NERL provides an update on key price control building blocks by 10 December 2021 so that we will have sufficient time to analyse the information NERL provides and consult NERL and other stakeholders on the results of our assessment. We will discuss the scope and requirements for this building block update with NERL, but we would expect it to include NERL's view on the building blocks used to calculate user charges with focused commentary on key areas.

## Guidance for business plan and consumer engagement

12. The March 2021 Update noted that we had provided extensive guidance about development of the business plan for RP3, much of which remains appropriate for NR23.<sup>2</sup> In its response, NERL noted that it would proceed with its business plan on the basis of our RP3 guidance, although it noted areas where it considered updates to the guidance were required.
13. We acknowledge that there are several areas where we should provide updated or additional guidance. We have developed five additional guiding principles for the development of NERL's NR23 business plan detailed in chapter 2, to be considered alongside existing RP3 guidance, which mean that NERL should:
- a) develop business plan scenarios that take into account key factors and circumstances that may impact on traffic recovery and likely future capacity;
  - b) set out the key drivers for its operating expenditure ("opex") and capital expenditure ("capex") for the NR23 period to allow for stakeholders to comment on areas where there are options and trade-offs to be made;
  - c) demonstrate clear links between costs and service outcomes for the different scenarios agreed between NERL and stakeholders;
  - d) consider how best to mitigate uncertainty; and
  - e) demonstrate how it has taken consumers into account in developing its business plan.
14. On the process for customer engagement, NERL said that:

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<sup>2</sup> CAA, "Economic regulation of NATS (En Route) plc: Update on approach to the next price control review", CAP 2119, March 2021

- the principles from RP3 remained relevant; and
  - any update to our guidance should acknowledge both the impact of the current exceptional circumstances on the UK aviation sector, and the limited time and customer resources available to support consultation.
15. Our view is that, given the time and resource constraints, it will be especially important that:
- this engagement is iterative and involves NERL sharing its thinking, options and views on trade-offs as its planning progresses and ahead of providing a full business plan. It should do this to allow as much time as practicable for meaningful engagement with stakeholders and for NERL to take account of customers' views in its business plan. This could include NERL taking a more flexible approach to separating out engagement on key topics and sharing its initial thinking as its proposals are being developed. We recognise that any early information should be treated as preliminary and that we and stakeholders should expect this information to evolve; and
  - we engage more proactively with NERL and stakeholders than in previous customer engagement processes, to better understand NERL's proposals and the views of stakeholders on them as they develop. This is consistent with views expressed by the CMA that we should set out our views earlier in the review process.
16. We support NERL's plan for initial customer engagement in June 2021, with in-depth consultation in October and November 2021.

## Reconciliation review

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17. In the March 2021 Update we provided our latest thinking on the challenges and policy options for the 2020 to 2022 reconciliation as follows:
- we intended to reconcile costs and revenues based on estimates of efficient costs rather than actual costs;
  - the review of the efficient cost baseline should be either a focused review of the building blocks or some form of variance analysis;
  - the requirements on NERL and airlines to provide the information required to support an approach should be reasonable and proportionate;
  - we would seek to complete as much of the review as practicable during 2021;
  - on the review of 2022 costs, we intended to adopt a similar approach as to 2020/2021, but this will be based on forecasts as opposed to actual costs; and

- we would aim to make any final adjustments to NERL's revenues to both protect NERL's financeability and to allow for an affordable level of charges and so support the recovery in demand for air traffic.
18. In their responses to the March 2021 Update, NERL and stakeholders broadly supported our approach. Some airlines did caution that a reconciliation for 2022 that is based on forecasts may result in unintended consequences for economic incentives. NERL said that our review should focus on the most important cost items and those which have shown the greatest variance from the CMA's determination, and that care should be taken in applying any benchmarking information.
19. Having considered these comments, we have made some updates to our approach to reconciliation, including:
- instead of completing the reconciliation during 2021, we now plan to complete this in 2022 as part of the NR23 process;
  - we will use outturn data for 2020 and 2021 and available forecasts for the remainder of 2022. If appropriate, we will conduct a further true-up in 2023, once information on outturn costs for 2022 is available. We would only expect to need to do a true-up if there seemed to be significant variation between forecast and outturn efficient costs;
  - the reconciliation review will involve assessment of the main price control building blocks that relate to costs and volumes and focus on the most material issues; and
  - we will be requesting a submission from NERL with its business plan that should allow us to progress our work on the reconciliation review. It will be important that NERL clearly sets out, and provides appropriate evidence of, how it acted efficiently given the circumstances and information available to it at the time. In a similar way to our approach to *ex post* capex reviews we do not intend to use the benefit of hindsight to assess the efficiency of NERL's decisions.
20. We also said in the March 2021 Update that we will need to implement a modification to NERL's licence condition to replace the current TRS mechanism for the period covered by the reconciliation review. This is intended to prevent the automatic recovery of the revenue shortfall based on the current TRS with a two-year lag, which would likely cause an unacceptable spike in NERL's charges in 2022. We will set our approach to the recovery of these revenues as part of the NR23 process.
21. We welcome comments from stakeholders on our approach to the reconciliation review.

## Chapter 1

# Timetable

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## Introduction

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- 1.1 In the March 2021 Update, we explained the advantages of delaying the start of the new price control until January 2023, including allowing sufficient time for NERL to develop its business plan. We set out a provisional timetable for the price control review, which included a modification to NERL's licence in the autumn of 2021 to, among other things, disapply automatic application of TRS for 2020 and 2021 (which would otherwise lead to an inappropriate spike in NERL's charges).
- 1.2 This chapter summarises the views of respondents and explains our latest thinking and proposal for the timetable for NR23.

## Consultation responses

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- 1.3 In its response to our March 2021 Update, NERL asked that we defer the delivery date of its business plan to March 2022. NERL said this would allow it to better take account of information from the summer of 2021 and facilitate more effective user engagement.
- 1.4 NERL also suggested the CAA's review could be streamlined by focusing on priority areas and excluding some that were more recently and extensively covered as part of the CMA appeal process, such as capex governance.
- 1.5 Other stakeholders requested that the CAA set out a clear timetable as a priority as this would allow interested parties to plan their resources so that they might engage in the process.
- 1.6 Stakeholders, including NERL, also suggested that the reconciliation work be deferred until 2022.

## Way forward

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- 1.7 We recognise that our earlier proposal that NERL should provide a business plan by December 2021 would have meant a shorter period for NERL to develop its plans compared with RP3. We also understand that the impact of the covid-19 pandemic has created constraints on NERL's and airlines' resources.
- 1.8 We propose to extend the deadline for NERL to deliver its business plan to us to 7 February 2022. This will allow further time for NERL to develop its plans while still allowing us sufficient time to develop and consult on our price control proposals and the associated licence modifications. We also intend to defer the

reconciliation review to 2022 and include this as part of NR23. We expect this will also reduce the workload on NERL in 2021.

- 1.9 We do not expect NERL to follow the previous process of a fully formed initial and then revised business plan. We consider it is more important that NERL focuses on meaningful stakeholder engagement in the time available. This is likely to work best if NERL adopts a more agile approach to this engagement, including sharing its initial thinking with airlines and the CAA before it is fully developed. We set out our expectations for NERL's customer engagement more fully in chapter 2.
- 1.10 Ahead of submission of its business plan, we propose that NERL provides a building block update to the CAA by 10 December 2021. This will allow us to start our analysis of NERL's forecasts of key building blocks at the end of 2021, while allowing NERL additional time to finalise its business plan. We will discuss the scope and requirements for this building block update with NERL, but we would expect it to include NERL's view on the building blocks used to calculate user charges with focused commentary on key areas. There will also be an opportunity for NERL to provide a further update on the building blocks as part of its response to our initial proposals.
- 1.11 Under our updated timetable, we would publish the final notice of licence modifications in January 2023. Once they come into effect, these licence modifications would apply retrospectively from 1 January 2023. Where there is a difference to actual prices charged in 2023 and those allowed by the licence modification, we would expect NERL to operate a true-up that is recovered over the remaining years of the new price control.
- 1.12 While the relevant provisions of the Air Traffic Management and Unmanned Aircraft Act 2021 ("ATMUA Act 2021") have not yet come into force, for the timetable we have assumed that the statutory framework that will govern the licence modification process will be the new regime in the Transport Act 2000 as amended by the ATMUA Act 2021. This means that we can modify licence conditions without needing NERL's consent, subject to appropriate stakeholder consultation, with NERL, materially affected airlines and prescribed aerodromes having a right of appeal to the CMA.

## Key dates

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- 1.13 We set out below our current view of the key dates for the work on NR23. We will keep the timetable under review as NR23 progresses.