

Economic regulation of NATS (En Route) Plc: decision on licence modifications to implement exceptional measures

CAP 2279

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About this document

This decision relates to changes to the price controls for NATS (En Route) Plc's (NERL's) regulated activities under its air traffic services licence for the year 2022, following on from the policy set in our December 2020 consultation (CAP1994), March 2021 update (CAP2119) and June 2021 update (CAP2160) and notice under section 11A(1) of the Transport Act 2000 of the proposed modifications that the CAA intends to make to NERL's licence (CAP2245).

This document constitutes notice under section 11A(5) of the Transport Act 2000 of modifications that the CAA has decided to make to NERL's licence.

We set out our decision to disapply the automatic calculation of the traffic risk sharing mechanism used to set the maximum Eurocontrol and London Approach service charges in 2022. These charges would otherwise increase sharply to recover allowed revenues from 2020 as a result of the reduction in traffic levels due to covid-19 pandemic. The main purpose of these modifications is to disapply this automatic calculation of the traffic risk sharing mechanism for 2022. Instead, allowed revenues will be recovered over a longer period of time to smooth the impact on charges to airspace users. The period of recovery will be determined through the next price control review (NR23).

The decision also includes modifications for exceptional measures to remove service quality incentives for 2020 that have been unduly affected by the impact of covid-19 on traffic levels, and further technical modifications necessary to implement the CMA's determination for the period 2020-2022.

If you would like to discuss any aspect of this document, please contact Anna Muoghalu (anna.muoghalu@caa.co.uk).

Summary and introduction

Introduction

1. NATS (En Route) Plc (NERL) is the monopoly provider of en route and certain approach air traffic services (ATS) in the UK and is subject to economic regulation of its services under the Transport Act 2000 (the Act) and licence conditions. NERL's price controls set the maximum charges that it can recover from airspace users for its Eurocontrol en route, London Approach and Oceanic en route services.
2. The current price controls (following the CMA's determination) started on 1 January 2020 and will end on 31 December 2022. 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. The CMA decided that due to the uncertainty created by covid-19, we should review the price controls to take account of the impact of the covid-19 pandemic when better information had become available.
3. We set out in the June 2021 update¹ that we will complete a reconciliation of costs and revenues for the period 2020-2022 to take account of the impact of covid-19 as part of the next price review (NR23). However, as the current price controls include automatic adjustments that would significantly increase the maximum allowed charges in 2022, to meet our statutory duties we are making modifications to the NERL licence ahead of the NR23 decisions.
4. On 1 October 2021 we published a consultation document (CAP2245²) proposing the following modifications to the NERL licence to take account of these exceptional circumstances:
 - licence modifications to disapply the automatic traffic risk-sharing mechanism for 2022 charges; and
 - licence modifications to disapply the service quality incentive payments for 2022 charges.
5. Our consultation on these modifications ended on 29 October 2021. We received four responses to our consultation. The respondents supported the proposed licence condition modifications but raised some points on the policy principles guiding our approach to the recovery of revenue shortfall from 2020-2022,

¹ www.caa.co.uk/cap2160

² www.caa.co.uk/cap2245

including clarity on how affordability of charges would be considered, the 3Di annual review protocol and the approach to future traffic risk sharing. We are proceeding with the licence modifications that we consulted on and respond in chapters 1 to 3 to the points raised by respondents.

6. The modifications to disapply traffic risk-sharing (“TRS”) are considered an exceptional measure taken as a result of the impacts of covid-19 on traffic levels. These modifications relate to the automatic application of TRS to recover 2020 allowed revenues in 2022 charges. We expect to take a consistent approach at the NR23 price control review with the price control conditions relating to the automatic recovery of 2021 and 2022 allowed revenues. The final decision on this will be subject to a separate statutory consultation procedure as it will relate to adjustments for 2023 and 2024 charges respectively and will be part of the wider NR23 licence modifications. These measures are relevant to the current exceptional circumstances and are not intended to be the starting point for considering the appropriate TRS mechanism for the NR23 period.
7. In chapter 1 we discuss the licence modifications relating to TRS and the policy principles guiding our approach on the recovery of 2020-2022 allowed revenues under the TRS. We expect these revenues to be recovered over one or two price control periods to smooth the impact on airspace user charges, while continuing to take account of the financial impact on NERL. During the NR23 price review, we will carry out analysis on the efficient cost baseline for 2020-2022 and consider the timing of the recovery of TRS revenues, bearing in mind both the affordability of charges and financeability of the regulated company. We will set out our decisions on recovery of these TRS revenues in the NR23 initial proposals and final decision documents in 2022.
8. In chapter 2 we provide details of the licence modifications to disapply service quality incentives related to 2022 charges. As a result of the significantly lower than expected traffic levels in 2020, capacity delays were significantly below target levels and automatic application of these incentives would provide bonus payments from airspace users to NERL to be recovered through 2022 charges. As these payments are the result of exceptional circumstances outside NERL’s control, we will disapply these 2020 payments for 2022 charges. The approach was supported by NERL and other stakeholders. We would expect to take a consistent approach to any 2021 payments and, potentially, 2022 payments, depending on the extent of traffic recovery.
9. In chapter 3 we set out details of a licence modification that relates to the recovery of allowed revenues in 2020 under the CMA determination. The chapter also discusses the annual review protocol for the 3Di performance measure.
10. The modified licence conditions are included in Appendix A to this consultation.

11. The statutory framework that governs this licence modification process is the new regime in the Transport Act 2000 as amended by the Air Traffic Management and Unmanned Aircraft Act 2021. This means that we can modify licence conditions without NERL's prior consent, subject to appropriate stakeholder consultation. We consulted on these licence modifications in October 2021 in CAP2245. We are now exercising our functions to modify NERL's licence in accordance with our statutory duties and this document constitutes notice under section 11A(5) of the Act of the decision to modify NERL's licence.
12. NERL, and owners/operators of aircraft and owners/managers of prescribed aerodromes whose interests are materially affected by this decision, may apply to the CMA for permission to appeal this licence modification decision within six weeks of publication. The procedure is set out in sections 19A to 19F and Schedule A1 of the Act.
13. The modifications to conditions 21, 21a and 22 will take effect on 1 January 2022³.

³ Subject to paragraphs 6 to 8 of Schedule A1 of the Transport Act 2000. These provisions provide that, where an application for permission to appeal has been made, an application for a direction suspending the effect of the decision may be made to the CMA.

Chapter 1

Traffic risk-sharing mechanism

Introduction

- 1.1 In the December 2020 consultation⁴ and March 2021 update⁵ we said we would carry out a reconciliation of the TRS arrangements for 2020 to 2022, and integrate the recovery of an appropriate level of revenue in the next price control.
- 1.2 Respondents, including NERL, supported our intention to suspend the automatic application of the TRS mechanism in 2022 to avoid a steep increase in charges which could be unaffordable at a time when traffic was still relatively low due to the impact of covid-19. 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, contributions from Government and contributions from shareholders.
- 1.3 In the March 2021 update we confirmed that, consistent with our statutory duties, we were seeking to develop an approach which delivers both affordable charges and supports NERL's financeability and efficient operation. We confirmed that we would carry out a reconciliation of costs and revenues for 2020 to 2022 and allow the recovery of revenue shortfall over a longer period than the automatic current two-year time lag. We also did not rule out setting price control arrangements on the basis that NERL's shareholders may need to provide additional support to the regulated business in response to the unprecedented and exceptional circumstances.
- 1.4 In the June 2021 update we confirmed our plans for the licence modification proposal and said that, as well as consulting on modifications to NERL's licence, we would address the policy principles that will guide our approach to the recovery of revenue shortfall from the 2020 to 2022 reconciliation review. We would then set out our approach to the recovery of the TRS revenue shortfall as part of the NR23 process.

Policy principles regarding recovery of 2020-2022 TRS revenue shortfall

- 1.5 In the October 2021 consultation, we explained that we were not making any decisions at this stage on recovery of this revenue shortfall, as we would need to consider affordability of charges and financeability in the round as part of the

⁴ www.caa.co.uk/cap1994

⁵ www.caa.co.uk/cap2119

NR23 review. However, recognising the value in providing NERL and airspace users with further clarity, we provided the main principles that will guide our approach.

- 1.6 We said we will reconcile costs and revenues for 2020, 2021 and 2022 on the basis of estimates of efficient costs and this will form the basis for the calculation of the TRS recovery amount. We also said that to the extent it is reasonable, we will look to allow NERL to recover the TRS revenue shortfall throughout NR23 with outstanding amounts recovered in NR28, subject to assessments of affordability and financeability.
- 1.7 We confirmed that the TRS revenue shortfall will continue to be accounted for in NERL's regulatory asset base (RAB) through a debtor in the movements in working capital⁶ with the amount unwinding as revenue is recovered. We also said we considered it appropriate to provide an allowance for financing costs or time value of money for the TRS recovery but did not conclude on a precise approach.
- 1.8 We also reiterated our previous position that we cannot at this stage rule out setting price control arrangements on the basis that NERL's shareholders provide additional support to the regulated business.

Representations

- 1.9 NERL was generally supportive of the policy principles. It cautioned against the benefit of hindsight when assessing efficient costs for 2020 to 2022 and considered the burden of proof should be on the CAA to determine that costs were inefficient.
- 1.10 With regard to financing costs, NERL considered that the shortfall should be adjusted for the full WACC because:
- i) the debt and equity funding of the TRS revenue shortfall has come from funding which assesses NERL as a whole;
 - ii) the debt funding came initially from pre-existing bank facilities. The equity funding has arisen from dividend restraint over a number years. NERL's cost of debt and capacity to raise the level of debt have been underpinned by this dividend restraint and initial low gearing;
 - iii) shortfalls did not arise from a business decision to lower prices but rather from the operation of the regulatory mechanism in the face of an unprecedented demand shock;

⁶ See NERL's 2020 Regulatory Accounts available [here](#), page 18.

- iv) NERL has one market into which it sells, one technology and one regulatory model, and considered this is unlike other regulated businesses where the regulator may set a different WACC for different parts of the business;
- v) TRS is already reflected in the WACC so the effect of such shielding is already reflected in the method to determine NERL's WACC. Customers have also benefited from the TRS by virtue of a lower cost of capital.

- 1.11 EasyJet supported recovery over a longer period of at least ten years and cautioned against recovering the majority of the amount over the initial five year period. It said a shorter period of recovery would be insufficient to relaunch traffic and that the cost of the pandemic is falling disproportionately on the airlines. easyJet believed that NERL should absorb a fair share of losses and use profits from RP2 to offset them, with state-funding being the primary source for the remainder of the shortfall. It considered access to the debt market should be investigated and cautioned against shareholder funding resulting in airlines absorbing the impact. EasyJet supported the use of profiling so higher amounts are recovered in later years but did not support including an allowance for financing costs.
- 1.12 Ryanair did not support proposals to recover the TRS revenue shortfall, especially over a time as long as two reference periods. It also objected to adding the amounts to the RAB and thought it was inappropriate to consider any financing costs given that five-year bonds were being offered at favourable rates during the pandemic. Ryanair said that NERL's shareholders should provide the necessary support and airlines should not be unduly penalised for circumstances outside of their control.
- 1.13 Prospect highlighted the need for clarity on the term "affordability of charges", especially given the relatively low proportion of air traffic management (ATM) costs within the average airline ticket price.

Next steps

- 1.14 We welcome the feedback on the approach to the recovery of TRS revenue shortfall from 2020-2022.
- 1.15 We have considered similar arguments to those raised by respondents⁷ in establishing our policy principles. In our consultation document we did not rule out setting price control arrangements on the basis that NERL's shareholders may need to provide additional support to the regulated business, if there was undue pressure on affordability of charges or financeability. We also said that in reaching any such view we would seek first to use conventional regulatory levers and mechanisms to manage affordability, take account of wider price control

⁷ See responses to CAP1994 and CAP2160 available on the CAA website: www.caa.co.uk/natslicence

package, and consider our statutory duties, including to protect the interests of consumers and to have regard to NERL's financeability. As highlighted in our March 2021 update, it is important to note that it is not our role to decide whether further Government support should be provided as an alternative to regulatory intervention.

- 1.16 We continue to consider it is appropriate for the TRS revenues to be recovered in line with the policy principles we set out in the consultation. We will consider the views from stakeholders around profiling of TRS revenues, summarised above and provided through the NR23 customer consultation process, and we will consult further on our proposed approach to recovery of these TRS revenues in our NR23 initial proposals.
- 1.17 We also continue to carry out work on better understanding and defining affordability which will feed into our NR23 initial proposals next year.
- 1.18 As mentioned in previous publications, we consider that final decisions on the recovery of TRS revenue shortfall can only be made once we assess and consider affordability of charges and NERL's financeability in the round as part of the NR23 review.
- 1.19 We expect the next substantial update on this subject to be made as part of our initial proposals for NR23. We have retained the policy principles provided in the October 2021 consultation, which are set out in Appendix C.

Licence modifications for 2022 charges

Proposed licence modifications

- 1.20 As explained above, as an exceptional response to the covid-19 pandemic, the associated downturn in traffic and resulting difference between allowed and actual revenues under TRS, we proposed to modify the licence conditions so that the TRS adjustment for 2022 charges is set to zero.
- 1.21 We estimated that under previously existing licence conditions the TRS revenue shortfall from 2020 to be recovered in 2022 would be around £380 million.

Representations

- 1.22 All respondents supported our proposal to set the TRS adjustment for 2022 charges to zero.

Licence modifications

- 1.23 For the reasons stated above and noting support from respondents, we are making the licence modifications to conditions 21 and 21a set out in the October consultation. The modifications are included in Appendix A.

Chapter 2

Service quality incentives

Introduction

- 2.1 As part of the RP3 determination, service quality incentives were set for environmental (3Di) and capacity (delay) targets. In 2020, the delays recorded by NERL were significantly below its capacity service quality targets. Under the current licence conditions, NERL would earn bonus payments in its 2022 charges. NERL also met its 3Di environmental performance target although there were no bonus payments associated with this.
- 2.2 The targets for delays in 2020 onwards did not reflect the impact from a significant downturn in traffic in 2020 and into 2021. In its response to the March 2021 update NERL acknowledged that it would not be appropriate for NERL to seek to recover from users these bonuses given that the achievement of the targets was materially easier while traffic remains well below anticipated levels. NERL therefore supported disapplying these incentives for 2020 to 2022. NERL also considered that equally, it should not be subject to penalties if traffic returns much quicker than expected over this period.
- 2.3 In our June 2021 update we set out our intention to disapply the 2020 incentives. We agree that the targets set for RP3 are no longer appropriate given the change in circumstances since they were set. We also think that given continued uncertainty and the concentration of efforts on the next price controls starting in 2023, it would not be appropriate to review the established targets used for incentive schemes in 2020.
- 2.4 We also said we would consider the same approach for 2021 if traffic levels remained substantially below the baseline. In the meantime, we said that we would continue to monitor NERL's performance against the targets set for RP3. We intend to continue our usual activities in monitoring NERL's actual performance and will seek further information from NERL where the targets are not met. We also said we will conclude on the year 2022 as the path of traffic recovery becomes clearer.

Licence modification for 2022 charges

Proposed licence modifications

- 2.5 The modifications in the consultation related only to the adjustment for financial incentives from the year 2020, which under existing licence conditions would otherwise be fully carried over into 2022 prices. Under the existing licence

conditions, NERL would be entitled to bonus payments for its C2 and C3 financial incentive targets, up to 0.3% of determined costs, or around £2 million.

- 2.6 Rather than removing the RP3 incentives from the terms of the licence, for the purpose of the 2022 charges, we proposed to state that the relevant terms in condition 21 will be equal to zero. This highlighted the extraordinary nature of this adjustment and NERL should continue to deliver a high-quality service.
- 2.7 We also said we expected to take a consistent approach to 2021 and, potentially, 2022 incentives, if traffic levels remain substantially below the baseline.

Representations

- 2.8 All respondents supported our proposal to set the relevant service quality terms from 2020 in condition 21 to zero, for the purpose of 2022 charges.
- 2.9 NERL requested that the CAA take a consistent approach to service quality incentives (bonuses and penalties) relating to 2021 and 2022 given the continued uncertainty while the industry recovers from the pandemic.
- 2.10 Ryanair considered that any bonus payments should also be suspended for 2021 and 2022 but that NERL should remain subject to penalties for this period. It considered NERL had sufficient data available on traffic recovery, including from STATFOR, to be able to plan for it and meet the previously set targets.
- 2.11 Ryanair also asked the CAA to clarify what it meant by 'baseline' when saying in paragraph 2.7 of CAP2245 that *"we anticipate the same approach to apply to 2021 and, potentially, 2022 incentives, if traffic levels remain substantially below the baseline."*

CAA views on representations

- 2.12 Traffic levels in 2021 continue to be significantly below 2019 and forecasted levels. As mentioned in the consultation document, we anticipate the same approach to apply to 2021 and, potentially, 2022 incentives, if traffic levels remain substantially below the baseline. Consultation on the relevant modifications will only take place next year as they relate to 2023 prices under the n+2 adjustment mechanism but we will look to confirm this approach as part of the NR23 review, including as part of our initial proposals.
- 2.13 With regard to Ryanair's request for clarification, 'baseline' referred to the traffic forecast underpinning the RP3 price control review.

Licence modifications

- 2.14 Bearing the above in mind we are making the licence modifications to condition 21 as set out in the October 2021 consultation. The licence modifications are included in Appendix A..

Chapter 3

Other licence modifications

Introduction

- 3.1 In addition to consulting on the modifications in chapters 1 and 2, we also proposed a modification to allow for the recovery of allowed revenues in 2020 consistent with the CMA's determination.
- 3.2 We also took this opportunity to consult on the annual review protocol for the 3Di performance measure.

CMA uplift (temporary unit rate adjustment)

- 3.3 In December 2020 we implemented the CMA's decision on price controls from 2020 to 2022 retrospectively from 1 January 2020.⁸ As part of the consultation, we noted that NERL's allowed charges to users for 2020 for UKATS, Oceanic and London Approach were set according to our RP3 decision, whereas the CMA's final report and determination allowed a higher level of revenues and user charges in 2020.
- 3.4 Although the process for adjusting revenues due to an application of a temporary unit rate is foreseen in the Eurocontrol framework (and features in the cost reporting tables), the term has not been previously included in the NERL licence. We proposed to allow this adjustment in the year 2022 and included an additional term in the price control formulae in conditions 21, 21a and 22. The impact on Eurocontrol service charges in 2022 was an increase of around £4.6 million.

Representations

- 3.5 NERL supported the proposed modifications noting also that the CMA uplift could alternatively be rolled into the reconciliation exercise. The proposed modification was preferable though as it ensured the adjustment is made as soon as possible, in a transparent manner and did not unnecessarily add to the task of reconciling costs and revenues.
- 3.6 NERL also pointed out that the formulae for the Oceanic price was expressed in annual rates and therefore the CMA uplift term did not require a traffic multiplier at the end of it.

⁸ www.caa.co.uk/cap2011

CAA views on representations

- 3.7 We agree with NERL that the proposed timing of the CMA uplift is preferable.
- 3.8 We agree that the traffic multiplier for the Oceanic price control condition was erroneous and have corrected the term in the final modification.

Licence modifications

- 3.9 Bearing the above in mind we are making the licence modifications to conditions 21 and 21a set out in the October 2021 consultation. The modification to condition 22 is corrected as discussed above. The licence modifications are included in Appendix A.

3Di annual review protocol

- 3.10 The licence modifications that implemented the CMA decision did not include the annual review protocol for 3Di for RP3. The protocol is not embedded in the licence and does not require a licence modification. It was included in the October 2021 consultation for completeness and to facilitate our review of NERL's 2020 performance.

Proposed approach

- 3.11 We proposed not to make changes to the annual review process compared to the process established for RP2. We said that for NR23 we will consider possible adjustments, including expanding the data set used for the purpose of the annual review, if 3Di is retained as a service quality measure.

Representations

- 3.12 NERL supported the proposed simplified approach to the annual review process for the RP3 period (2020 to 2022). However, NERL did not agree with the proposed method for accounting for non-revenue flights.
- 3.13 NERL said that actual share of non-revenue flights in 2020 meant that the impact on the 3Di score was closer to -2.0. Therefore, it did not agree with the draft protocol which asked them to provide data for the purpose of the ex-post review adjusted by -0.6 and said the score should be updated for the actual impact.

CAA views on representations

- 3.14 Ahead of RP3, we agreed with NERL's proposal to remove non-revenue flights from the calculation of RP3 targets. As part of our consultation and later decision, we decided to adjust the targets by -0.6 based on historical impact of such flights on the 3Di score, as provided by NERL. The RP3 targets did not