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20 December 2019

Judith Ross
NATS/CAA regulatory appeal
Competition and Markets Authority
The Cabot
25 Cabot Square
London E14 4QZ

Dear Judith Ross,

NATS En-route Limited (NERL) Price Determination Appeal

This response is completely non-confidential and may be published on your website.

Citizens Advice has statutory responsibilities for representing the interests of energy consumers in Great Britain (GB). Whilst this NATS En-route Limited (NERL) appeal, referred by the Civil Aviation Authority (CAA) to the Competition and Markets Authority (CMA), relates to the aerospace market sector, we consider it relevant enough to other sectors (such as water, telecoms and energy in particular, where we are the statutory advocate) for us to respond. Regulators in the UK have a history of referring to and learning from determinations in other price controls[1] (i.e. they are not entirely distinct decision making processes). As such, Ofgem will look to the outcome of this appeal to inform its own determination for the RIIO-2 price controls, which will directly impact the outcomes for energy consumers in GB. Citizens Advice (and as Consumer Futures and Consumer Focus previously) has a strong history of informing regulatory decisions made by Ofgem, through bringing relevant information and evidence to the attention of that regulator. Consequently, we consider it within our remit to respond to this appeal and that this response falls well within the bounds of our statutory duty to represent the

[1] Indeed, the CAA clearly state (Document: CAP 1857, RP3 reference CAA document 002, p29) that in setting the WACC for RP3 they referred to recent consultations and determinations from other UK regulators, including Ofwat, Ofcom and Ofgem, as well as the cost of equity study by Professor Wright et al. for the UK Regulators Network (UKRN).

interests of energy consumers in GB. As stated by the CMA[2], third party submissions will be taken into account where those submissions cover issues with potential read-across to other cases and where they are directly relevant to the NATS determination (and therefore would help the CMA in this case). We consider this submission to fall safely within that category.

Overall we are supportive of the cost of capital the CAA has set in its determination. In this response, we focus on what we see as the primary issue of difference between the CAA and NERL: the cost of capital. On a vanilla WACC basis, the CAA's final decision of 2.68% (real RPI) compares to NERL's final position of 4.21%, and over 90% of this divergence of position relates to different views on the appropriate cost of equity for NERL's activities. As such, we are providing our views on aspects of the appropriate cost of equity, specifically the two components that account for the majority of the gap between the CAA's decision and NERL's: the total market return (TMR) and the relative risk profile (measured by beta metrics). The CAA's assessment is that NERL's equity should be remunerated on the basis of a company with a risk profile consistent with the average for the overall market. Whilst we appreciate the simplicity and measurability of this, we consider that even this approach is relatively generous to NERL's shareholders.

Total Market Return

The CAA's approach to setting the TMR is underpinned by several factors. These cover the approach used in the UKRN cost of equity report using long-term historical returns (including information from the Credit Suisse Global Investment Returns Yearbook), recent market trends (which point to a significant reduction in the risk-free rate and expected returns on equity) and consistency with other recent regulatory decisions (e.g. Ofgem's RIIO-2 and Ofwat's PR19). Whilst we provide qualified support for this general approach (which aims to retain a TMR of 5.4% in RPI-deflated terms) as it is around the midpoint of the ranges from different sources and approaches, we still consider this to be a generous approach in the current climate. As detailed in our 2019 RIIO-2 sector-specific consultation response[3], we do not wholly agree with the assertion that a long run TMR is

[2] https://www.gov.uk/cma-cases/nats-en-route-limited-nerl-price-determination.

[3] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-consultation-responses/riio-2-sector-specific-consultation-citizens-advice-submission/.

always an appropriate approach. Since the early 1900s the economy has experienced distinct economic phases, some of considerable duration (see Figure 1 below, from CEPA's 2018 review of Ofgem's RIIO-2 cost of capital ranges, which takes data from the Credit Suisse Global Investment Returns Yearbook 2017).

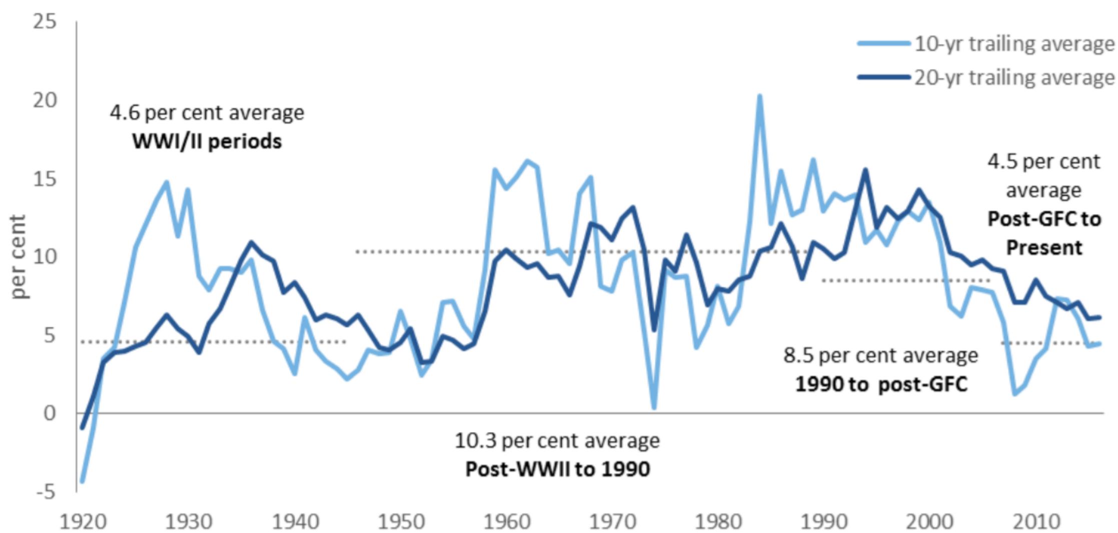

Figure 1 - Historical real equity market returns in the UK (graph from CEPA[4])

As an example, if the long run average was applied in 1990, then this would be incompatible with the environment at the time. The current market environment is considerably different from a century ago, and using a more appropriate (shorter run) TMR will lead to a more suitable metric. In our view, there is no evidence to support the approach of starting the data series more than half a century ago. When assessing the CAA's final determination for the period 2020 to 2024, we would encourage the CMA to consider supplementing 10-year and 20-year trailing average outturn TMR data up to 2019 with a simulation of expected returns for years 2020-2024. Providing the CMA were mindful of any risks (including forecast errors) that this approach might introduce, this could be a useful way of combining outturn TMR data with various expectations of TMR for the next four years.

NERL claim that the RP3 estimated TMR (when compared to the RP2 TMR) implies an unacceptably large and rapid reduction in equity returns and productivity. Our view is that it is right and proper for a regulator to reflect new evidence in its approach to setting

[4] CEPA, 2018. CEPA analysis of Credit Suisse Global Investment Returns Yearbook 2017. Available (page 105): https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa_report_on_baseline_allowed_returns_for_riio-2.pdf.

such metrics. In this case, we consider the CAA to have considered a range of alternative evidence bases and arrived at a reasonable position (that if anything, is generous to NERL's shareholders).

Risk profile and beta

Due to the lack of observable market data from stock exchanges, any approach to addressing this aspect of the cost of capital will be less than perfect. Broadly, the CAA's approach of estimating betas based on ENAV (a listed air traffic control comparator in Italy) and wider comparators (e.g. beta estimates from companies that share or have somewhat similar risk characteristics, including UK utilities and international airports) - coupled with further cross-checks - seems reasonable. Indeed, we consider CAA's approach to setting the ultimate equity beta (arriving at a figure of 1.0 in their final decision) to be somewhat generous to NERL's shareholders. NERL enjoys significant risk protections (including full pass through of its exceptionally high pension costs) and we are unaware of any evidence that NERL is as risky as the wider market.

Our view is that NERL is likely to be less risky, suggesting an equity beta lower than 1.0, and so the CAA's current position could be viewed as conservative. As a comparison, in RIIO-1 Ofgem set the equity beta in the range of 0.90 to 0.95[5], which (using market data) we argued was too high in our 2017 report Energy Consumers' Missing Billions[6]. Ofgem have since updated their assessment and working assumption for the notional equity beta range for RIIO-2 (for transmission and gas distribution companies), and are considering a range of 0.66-0.85[7] (with a midpoint of 0.75). This demonstrates how regulators can allow overly-generous beta estimates (by aiming up), and suggests that the CAA's final decision of 1.0 (for the equity beta) is likely to be at the top end of the actual range.

NERL claim that when compared with the RP2 asset beta, the RP3 estimated asset beta implies an unjustified reduction in systematic risk. As with the TMR, our view is that it is

[5] See https://www.ofgem.gov.uk/system/files/docs/2018/12/riio-2_finance_annex.pdf para 3.38 (p20).
[6] See https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/energy-consumers-missing-billions/.
[7] See https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf para 3.178 (p57).

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entirely appropriate for a regulator to reflect new evidence and improve its approach to setting such metrics, otherwise they will always be held hostage to past decisions.

We hope that you find this response helpful and clear. Please contact me if you wish to discuss anything in this submission in more detail.

Yours sincerely

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