INTERNATIONAL AIRLINES GROUP

Ms Judith Ross
NATS/CAA Regulatory Appeal
Competition & Markets Authority
The Cabot, 25 Cabot Square
London E14 4QZ

By post & email to: nats.caa@cma.gov.uk

23rd December 2019

Dear Ms Ross,

Re: NATS En-route Limited (NERL) Price Determination

On 12th December 2019 we sent the CMA two papers that we had commissioned from CEPA LLP, on the appropriate cost of capital for RP3:

- CEPA (Nov 2018) "Cost of capital for NATS (En Route) plc", an unpublished report shared with the CAA; and
- CEPA (April 2019) "Response to CAA consultations on RP3 and H7 WACC", publicly available on caa.co.uk.

The first paper sets out CEPA's initial analysis of the appropriate cost of capital range for RP3, including a review of NERL's proposals and its supporting evidence in reports from NERA, dated March and September 2018. The second comments on the CAA's draft cost of capital proposals (CAP1758) and addresses comments from NERL and NERA on the earlier CEPA study. CEPA's work was undertaken on an independent basis, drawing on its wide experience of undertaking cost of capital analysis in regulated sectors.

As an interested party, we request the opportunity to present findings to the CMA. In particular, we consider the following to be important to a CMA determination of the cost of capital.

1. **Our independent analysis provides strong support for the CAA's RP3 cost of capital determination.** The CAA's final determination of a 2.68% real (RPI) vanilla cost of capital is close to the mid-point of CEPA's independently calculated November 2018 range of 2.21% to 3.34%. CEPA found the cost of capital proposed by NERL to be significantly higher than could be justified by the available evidence.
2. **Our independent analysis supports the CAA's position on the two main points of difference between the CAA and NATS: total market returns and the asset beta.** CEPA found it was appropriate for the CAA to put no weight on regulatory precedent on total market returns in the context of a growing consensus among UK regulators that previous determinations had been overly generous on this point. The CAA's asset beta point estimate fell within CEPA's range; NATS' proposed value was materially higher.

3. **CEPA's analysis provides support for the CAA's cost of capital determination despite differences of approach on individual parameters.** For example, CEPA preferred the use of index-linked gilts to calculate the risk-free rate rather than deflated nominal gilts.
4. **We conclude that in some areas the CAA could have reasonably gone further in reducing the cost of capital relative to RP2.** CEPA found that the allowance for the cost of new debt risked over-compensating the efficient cost of debt for NERL. In relation to the asset beta, CEPA also considered that there was evidence consistent with an estimate below the CAA's decision of 0.46.

We believe CEPA's analysis provides valuable evidence for the CMA on the most central issues for the NATS RP3 appeal. However, it is also important to underline the wider implications of the CMA's determination, which include the following.

1. The CAA's RP3 determination on the cost of capital is reflective of a broad-based shift among UK regulators towards material reductions in the cost of capital in the upcoming round of regulatory determinations. This is driven by economy-wide changes and methodological considerations, not just NATS-specific factors.
2. The CMA's determination on the cost of capital for the RP3 appeal will set an important precedent for the current wave of price control determinations in a range of regulated sectors. The CAA's determination reflects work undertaken by the UKRN and other regulators. The CAA's judgements cannot be seen in isolation and the CMA should recognise the weight its decision will have across a range of sectors.
3. The CMA's determination will set a particularly strong precedent for the CAA's upcoming H7 determination, which will have substantially greater financial impact on the airline industry in the UK than RP3—HAL's RAB is already over ten times the value of NERL's even before the development of new runway capacity. Any overcompensation in the RP3 control could have a serious impact given the scale of the work to be undertaken at Heathrow, and the resulting cost to be borne by airlines and their passengers.

We would anticipate that an uninterrupted presentation of this material by CEPA might take around 30-45 minutes, and might be followed by a similar period of questions and answers. Should this turn out to be insufficient time, then of course, we can make further arrangements, but in the meantime, I would be grateful if you would indicate if and when you would be willing to hear CEPA.

Yours sincerely,

[redacted]

Ian Clayton
Group Head of Regulatory Affairs