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NATS/CAA Regulatory Appeal
Competition and Markets Authority
The Cabot
25 Cabot Square
London
E14 4QZ
United Kingdom

16th January 2020

FAO: [redacted]

Dear [redacted]

<u>Referral from the Civil Aviation Authority ("CAA") to the Competition and Markets Authority ("CMA"):- NATS En-route Limited ("NERL") Price Determination – Third Party Representations</u>

Virgin Atlantic Airways (VAA) welcomes the opportunity to comment on the above "Referral", as published on the 20th November 2019.

As an airspace user we are generally supportive of the position taken by the CAA, apart from the Authority's stance on the Oceanic settlement, over which we have notable disagreements. In this respect we fully support the submission made by the International Air Transport Association (IATA), which concentrates on the Oceanic settlement aspects.

In responding to this "Referral" we note the information submitted by the CAA (and NERL) and published by the CMA as "Main Party Submissions".

Firstly we would like to make some particular points on the subject of the Weighted Average Cost of Capital (WACC), as described in the proposed RP3 settlement and these are set out below;

We understand that for the RP3 determination, the CAA have estimated a point estimate cost of capital of 2.68%, towards the lower end of the range estimated by PwC, their appointed consultants. We note that NERL strongly disagrees with this point estimate and claim that their proposed WACC of 4.21% is more appropriate. The disagreements have been mainly over the Total Market Returns (TMR), Beta and the Cost of Debt issuance.

Overall, we agree with PwC's estimated WACC range. They have used multiple methodologies to estimate each input, considered regulatory precedents and to some extent even marginally overestimated some of the inputs for future uncertainties. They have also taken account of stakeholders' responses and have made further adjustments to the WACC, defining a final range of 2.5% to 3.4%. We therefore believe that the CAA estimate of 2.68% is reasonable.

NERL claims that the TMR is significantly (0.85%) lower than that in RP2, which is a return that is *"inconsistent to economic evidence and the change from one price control to the next is unfeasibly large"*[1]. However, we need to understand that equity returns over recent years, including recent decades, have been lower in comparison to longer historic returns and that this is clearly observed not just in the UK, but also other European equity markets (DMS). We would have also assumed that the RP2 decision may have given stronger consideration to the Global Financial Crisis (GFC). As more time has elapsed since the GFC, there is increasingly strong evidence that equity returns are dropping.

NERL also claims that the asset beta is significantly understated compared to RP2, from 0.505 in RP2 to 0.46. NERL claim that the CAA has not taken account of their gearing and only focuses on the fact that they are a monopoly and are unlikely to face above average market risks. We commend the CAA's stance in adjusting the beta. When commenting on the lower volatility on NERL's bonds in comparison to HAL's bonds, PwC say ***"In our view, this could be because NATS is a critical national asset with regulatory protections and government support. It also has significantly lower gearing, which reduces the probability of distress. These factors are reflected in the credit rating of the NATS bond, which at AA is higher than the rating of the HAL bonds considered in our analysis."***[2]. PwC also go on to state that the actual gearing level at NERL is closer to 30% in recent years compared to HAL's 75-80% gearing, which significantly reduces this risk.

NERL have also stated that they believe that the allowance made for cost of debt issuance is insufficient. We believe, however, that the cost of debt issuance is appropriately set at 0.1% as this represents an efficient cost of debt issuance and considers larger and smaller debt issuances from water companies between 1993 and 2017. Evidence from the same Europe Economics[3] report suggests that in more recent years (since 2000) the cost has dropped even further.

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[1] https://assets.publishing.service.gov.uk/media/5e0f6528e5274a0fa397ab35/NATS_reply_to_CAA_response_2020.pdf

[2] PwC Economics, August 2019, Estimating the cost of capital for H7 and RP3 - Response to stakeholder views on total market return and debt beta

[3] Europe Economics, PR19 Initial Assessment of the Cost of Capital

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It is vital that the CMA recognises that its determination on the cost of capital for RP3 will set a precedent for the upcoming H7 price determination covering the expansion of Heathrow Airport. Given the size and scale of that proposed scheme, the impact of rejecting the CAA's detailed evidence in this case will have significant ramifications for the cost burden on passengers and airlines at an expanded Heathrow.

VAA Overview of the CAA (Main Party) Submission:

In reviewing the position adopted and submitted by the CAA, we are particularly struck by their comments as laid out to the CMA. In summary;
The difference in RP3 total costs between the CAA and NERL is about £200m: with the largest differences being £125m for cost of capital and £45m for operational costs.
NERL is opposed to most other aspects of the CAA's decision, in particular the proposed capital expenditure governance changes for RP3, capacity targets and Oceanic proposals.
In more detail, the CAA have highlighted the following aspects, which we believe are worthy of being re-stated;

Operating costs [Chapter 8 of NERL's statement of case]

- NERL characterises the CAA's final decision as a reduction in Opex (including adjustments made for non-regulatory revenue) that will leave it unable to address increasing traffic, ensure sufficient ATCO resources and fulfil its airspace and technology modernisation programmes.
- NERL does not recognise that the CAA have allowed the significant increase (20%) in its costs in 2018 and 2019 plus the equivalent of its first three years of operating costs in its business plan. Furthermore for most of RP3 the CAA's operating costs allowance is greater than Opex in 2017.
- The efficiency challenge in the CAA's decision can be regarded as low, as they have sought to provide maximum flexibility for NERL to play its role in airspace modernisation.
- The CAA do not set out how many ATCOs NERL employs, but do note that its Business Plan includes an increase of 131 operational ATCOs in the first three years of RP3 (for which they have allowed its full costs) and an additional 20 extra ATCOs in the last two years of RP3.
- NERL's Business Plan includes an additional 54 other support staff by the end of RP3.
- NERL suggest that unless it receives its full operating costs it will not be able to deliver – suggesting that all the risk of non-delivery should be entirely borne by airspace users – rather than NERL shareholders.

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Capital investment governance [Chapter 13 of NERL's statement of case]

- At the start of RP2 NERL fundamentally changed its capital programme, delaying airspace modernisation and significantly increasing capital investment costs for RP2. While eventually there was general industry agreement on the outcome, there was significant debate around the approach NERL adopted, how well it discussed options with customers and whether it provided clear information.
- Given our experience of RP2, the importance of airspace modernisation and the additional flexibility in the CAA's RP3 operating costs decision, we agree it is essential that robust and effective capital governance arrangements are put in place for RP3.
- These should include financial incentives for NERL to provide sufficient information and for its expenditure to be cost efficient and delivered on time.
- We note with some concern the CAA's suggestion that NERL is looking to step back and reduce the rigour with which it engages on its programmes, including the valuable role that the Independent Reviewer can play in supporting both airspace users and the CAA in evaluation NERL's proposals.

Capacity [Chapter 6 of NERL's statement of case]

- NERL sets out that the capacity (delay) targets in the CAA's decision are too onerous, and would result in it failing to meet targets and incurring delay penalties in four out of five years of RP3.
- NERL does not recognise that except for the years in which it implemented significant transitions (for which it was proposing to be exempt from), it has historically outperformed its delay targets. Nor does it recognise that regardless of its exemption policy, airspace users will experience delay.
- The CAA have proposed delay targets in line with the European Network Operations Plan reference values – themselves based on NERL's own capacity plans – re-profiled to allow more delay to be incurred later in the period when significant transitions are scheduled to be deployed. They have also established lower financial incentives, to ensure that NERL is not unduly discouraged from making required transitions through fear of penalty.

Oceanic [Chapter 12 of NERL's Statement of Case]

- Please note that in reference to this section we have submitted another separate CMA submission in support of the submission made by IATA, which deals almost solely with the subject of space based ADS-B and the introduction and charging for those surveillance services over the North Atlantic.

- We are on this aspect at odds with the CAA's decision to allow space based ADS-B data costs in the RP3 Oceanic price control. We do however note the CAA's point regarding their primary duty for safety under the Transport Act requiring them to recognise the potential safety improvements that ADS-B can bring. But, we do not agree that given the projected safety and demand / capacity analysis, that the introduction of space based ADS-B surveillance is warranted at this time.

- We do note that the CAA have acknowledged, given the unproven nature of the level of operational benefits that space based ADS-B may bring, the monopoly nature of both NERL and its space based ADS-B data provider (Aireon), that they have applied some moderate efficiency challenge to the costs NERL is permitted to recover, including for space based ADS-B. The Authority is also reflecting concerns about the perception of conflict that NERL is buying space based ADS-B data from a company in which NATS Services Ltd (NSL) is an equity shareholder. Although welcome comments, this in our opinion does not go far enough in order to remove the burden of significantly increased charges for the Shanwick portion of the North Atlantic airspace.

Thank you for considering our above comments and we would be pleased to discuss any aspect of this response at a mutually convenient time within your review process.

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