

NATS (En Route) /CAA Regulatory Appeal

Summary of provisional findings report

24 March 2020

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The Competition and Markets Authority has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [X]. [Some numbers have been replaced by a range. These are shown in square brackets.]

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Summary

Background

1. NATS was formally separated from the Civil Aviation Authority (the CAA) by the Transport Act 2000 (TA 2000) and is a Public Private Partnership (PPP) between the UK Government, Airlines, Heathrow Airports and NATS employees. The core business of NATS is to ensure the safe separation of aircraft in UK controlled airspace through its operating subsidiary NATS (En Route) plc (NERL). NERL had revenue of £733 million in 2018/19.
2. NATS (En Route) plc (NERL) holds a licence issued by the Government under TA 2000 to provide en route air traffic service in the UK. TA 2000 also gives the CAA the role of economic regulator of NERL.
3. On 29 August 2019 the CAA published proposed modifications to NERL's licence (CAA Decision). These proposed modifications related to the economic regulation of NERL during the five years 2020 to 2024 (Reference Period 3, or RP3). NATS did not consider that the proposed modifications to the NERL licence were in the public interest and, given the difference between the CAA proposals and the NERL business plan, did not consider that they would allow NERL to provide an appropriate high level of service and operational performance whilst also delivering programmes of technology and airspace change. NERL told us that the difference in determined costs between the NERL plan and those allowed in the CAA Decision was £212 million, out of a total allowance of £2,956 million. NERL therefore rejected the CAA's proposed licence modifications and on 19 November 2019 the CAA made a reference to the Competition and Markets Authority (CMA) to report on the matters specified in the reference within a period of six months.
4. The reference requires the CMA to investigate and report on:
 - a) whether or not a failure to set price controls and impose the appropriate modifications to the RP3 licence would operate against the public interest or may be expected to do so (the first reference question);
 - b) if the CMA concludes that a failure to set price controls and impose conditions to NERL's licence would operate against the public interest, what modifications to the licence would remedy that adverse effect, and whether the conditions the CAA has proposed are adequate (the second reference question).
5. The matters referred to us for the purpose of this reference are:

- Condition 10 of NERL’s Licence, relating to business plans, service and investment plans, periodic reports
 - The Conditions relating to charge control (Charge Control Conditions):
 - Condition 21: Control of Eurocontrol Service Charges
 - Condition 21a: Control of London Approach Charges
 - Condition 22: Oceanic Charges
6. We undertook our investigation into these matters taking account of the fact that RP3 is an unusual period as NERL is undertaking a significant upgrade of technology systems to replace legacy equipment and deliver a new technical architecture, with the associated training needs. NERL will also have a key role in the airspace modernisation strategy intended to improve the efficiency of airspace management in the UK. While the CAA owns the strategy and plan, delivery (including the design of any airspace changes) is undertaken by other entities, such as airports, air navigation service providers or airspace users.
 7. NERL and the CAA (together, the Parties) agree that effective delivery of both the technology upgrade and airspace modernisation are in the public interest as they will deliver significant future benefits in terms of performance and resilience. We are also mindful of the primary duty of NERL being to ensure the safety of air traffic. In assessing the correct price controls we therefore carefully consider the need to balance the benefits from delivering this modernisation program at pace, with the requirement of NERL delivering a safe and efficient business-as-usual air traffic control service over the RP3 period.
 8. Most of the difference between the Parties’ views on determined costs is accounted for by the allowed regulatory return. This in part reflects differing views on how much risk NERL is taking over the RP3 period.
 9. During the course of our investigation, cases of Covid-19 began to appear and quickly became a pandemic. At the time of writing this report, it is clear that there will be a substantial impact on air traffic volumes and NERL operations, at least for 2020, as a result. There remains, however, considerable uncertainty about the extent and duration of this impact. Our investigation leading to our provisional findings was largely completed before the Covid-19 pandemic was established, and therefore reflects operating conditions prior to this event. We received a letter from the Parties on 20 March 2020 updating the CMA on the views of both Parties on the CMA Reference process in light of the evolving situation. We welcome views from

stakeholders on how we should take account of the impact of Covid-19 in our Final Determination. We will consult with the Parties on how the CMA Reference process should progress, following publication of our provisional findings.

Our approach to the reference

10. In addressing the reference questions, we need to consider whether the matters referred to us in the first question are against the public interest. In doing so, we are required to have regard to the duties that are imposed on the Secretary of State and the CAA by the TA 2000. These include:
 - a) the primary duty to maintain a high level of safety, and
 - b) secondary duties to:
 - further the interests of aircraft operators, aerodromes and end consumers where appropriate by promoting competition in the provision of air traffic services;
 - promote efficiency and economy by licence holders; and
 - secure that licence holders will not find it unduly difficult to finance activities authorised by their licences.
11. The Secretary of State and the CAA are also required to impose on licence holders the minimum restrictions which are consistent with the exercise of those functions.
12. TA 2000 requires us to conduct an investigation to decide whether the matters specified in the reference will operate against the public interest and, if so, to specify the appropriate licence modifications. We consider that we are not required to decide on judicial review grounds whether the CAA's decisions were wrong in law. Our approach, therefore, has been to build on, but not be unduly constrained by, the analysis already carried out by the CAA in its Decision. In considering the reference questions, the differences between the CAA and NERL informed but did not constrain our thinking. In the interest of proportionality, we gave appropriate weight to issues bearing in mind their likely effect on the price determination.

Whether a failure to set a price control and impose the appropriate modifications operates, or may be expected to operate, against the public interest

13. In considering the first reference question we noted that, as a result of NERL's having rejected the CAA's proposed modifications to its licence, there are currently no operative charge control conditions in NERL's licence. This is because the charge control conditions imposed for the last charge control period applied only until 31 December 2019. Thus, the consequence of NERL's rejecting the CAA's proposed modifications to these conditions for RP3 is that the conditions have ceased to have any effect. The modifications proposed by the CAA for Condition 10 to impose additional regulatory governance on NERL have no effect either.
14. Our view is that a failure by the CAA to set a price control and impose the appropriate modifications to NERL's licence to enable the CAA to exercise regulatory control over NERL in the RP3 period would clearly operate against the public interest and lead to adverse effects, including higher prices than necessary because NERL would not be constrained when setting prices in earning profits relative to its cost of capital, potential delay and inefficiencies in implementing the Airspace Modernisation Strategy.
15. In particular, licence modifications appear necessary to ensure that the price control:
 - Allows an appropriate remuneration of NERL's investments, properly reflecting the risks to which investors are exposed;
 - Provides NERL with the financial resources to achieve airspace modernisation while maintaining reasonable pressure on the organisation to continue to deliver operational efficiencies
 - Provides appropriate performance incentives for the protection of the quality of service provided to airspace users
 - Strengthens NERL's accountability for carrying out its investment plans by putting in place appropriate incentive arrangements and encouraging NERL to develop new and improved governance arrangements
 - Provides for technological enhancements in the Oceanic service necessary to create safety benefit for this operation

Whether the effects adverse to the public interest could be remedied by modifications to the licence conditions.

16. Having concluded that an absence of a price control would operate against the public interest, we considered what modifications to the licence would remedy such adverse effects, and whether the conditions the CAA has proposed were adequate. Where we have provisionally concluded that certain of the CAA's proposed modifications were not adequate to remedy the effects adverse to the public interest, we set out our view of alternative modifications by which we considered the adverse effects would be remedied or prevented.
17. We summarise below our views on each of the main elements of the price control. We then consider the price control 'in the round', including any interlinkages between the different elements, to ensure our decisions were balanced and provided consistent incentives while ensuring NERL's financeability. We were also mindful of the need to meet the objectives to achieve airspace modernisation and technology updates, as well as the ongoing duties of NERL and the CAA.

Service Delivery Targets

18. NERL is subject to four capacity performance targets based on measurements of flight delays. In addition, NERL is subject to a '3Di' environmental target which measures environmental performance in terms of flight efficiency, as a proxy for carbon emissions. The 3Di metric is based on both vertical and horizontal flight efficiency which are influenced by flight routing decisions.
19. We provisionally conclude that these targets, reporting basis and associated incentives should be applied in line with those proposed in the CAA Decision. We have not seen sufficient evidence to persuade us that it was unrealistic for NERL to maintain good performance, even during the delivery of the airspace modernisation programme.

Traffic Forecasts

20. Traffic forecasts are used to determine the unit charges for air traffic services, and therefore the choice of forecast influences the amount NERL receives for its services and the timing of the amounts received. A traffic risk sharing mechanism then adjusts the amount received to some extent two years after the fact, if the actual traffic levels turn out to be substantially different from the forecast used to determine the charges.

21. We considered whether it was appropriate to use for regulatory purposes the STATFOR traffic forecast prepared by Eurocontrol or the traffic forecasts prepared by NERL itself. Our provisional view is that it is appropriate for the CAA to use the STATFOR forecasts. For our Final Determination we therefore intended to use the latest STATFOR forecasts that were expected to be available in March 2020. However, we note that the situation with Covid-19 may result in these not being available in time, so at this point our approach is to signal our intention to update the traffic forecasts using the STATFOR update

Opex

22. Operating expenditure (opex) is the single largest component of NERL's price control, accounting for around 70 per cent of determined costs under the CAA Decision. NERL's revised business plan (RBP) included £2156 million of opex, to which the CAA Decision applied a £43 million reduction.
23. The Parties presented markedly different views on the level of stretch implied by the difference between the opex requirements NERL had identified in its RBP, and the opex allowance the CAA provided for in its Decision. For example:
 - c) The CAA described the opex efficiency challenge in its Decision as modest, and the opex allowance as relatively generous.
 - d) NERL said that the reductions in opex would result in it having many fewer controllers available to support its investment programme, and would create risks to ongoing safety improvements, resilience and other aspects of operational performance.
24. The CAA Decision provides an opex allowance that is around £43 million lower than that identified as required in NERL's RBP, a reduction of around 2%. NERL's RBP forecast an opex increase of 21% in real terms between 2017 and 2019 and identified opex requirements as increasing by around a further 5% in real terms through to 2022, before falling to a level at the end of RP3 that remained around 1% above the forecast 2019 level.
25. Given the extent of these proposed increases, we consider it important that the CAA, as the economic regulator, sought to carefully scrutinise NERL's plan and challenged the extent to which airspace users should be expected to fund the forecast increases in opex set out in NERL's RBP. We reviewed the range of evidence that the CAA took into account in its challenge to NERL's plan, in particular the extent to which airspace users might be expected to

fund forecast increases in opex. Based on that review we were not persuaded by NERL's criticisms of the CAA's assessments.

26. The CAA's decision to set an opex allowance that was lower than NERL had identified in its RBP, and the size of that reduction, necessarily involved its forming a judgement, in a strategic context where NERL has a key role to play in airspace modernisation and is part way through a major technology programme. We consider that the CAA carefully reviewed these priorities, alongside its duties to airspace users, in developing its Decision for RP3. We note, in particular, that its decision to apply a 2% reduction in opex relative to NERL's RBP sits alongside its acceptance that it was appropriate for the average opex allowance across RP3 to be around 20% higher than NERL's actual opex in 2017.
27. We consider NERL's concerns with respect to the potential operational and safety risks that might be associated with the CAA Decision to be misplaced, and to be out of line with the regulatory framework that applies.
28. We therefore provisionally conclude that the opex allowance should be applied in line with that proposed in the CAA Decision.

Capex

29. The price control sets the levels of capex allowed, and includes provisions related to the governance arrangements and incentives that apply to NERL's capex.
30. The CAA proposed an overall capex allowance for RP3 of £667 million, £48 million less than NERL's estimate in its RBP. We found the CAA's scaling down of NERL's capex forecast to be consistent with it having less confidence in the reliability of some areas of NERL's forecast spend where projects were not yet fully scoped. We consider it likely to be important that there is further engagement on and scrutiny of these projects, and their associated costs, during RP3 as NERL's plans evolve, and that the CAA Decision on the level of capex allowance is consistent with providing for this. We were satisfied, given the CAA's financeability analysis, that NERL should be able to fund capex that exceeded the allowance, should such additional spend be appropriate, providing the capex incentive arrangements are amended in the ways set out below.
31. We provisionally conclude that the capex allowance should be set in line with the CAA Decision.
32. We found NERL's concerns over developments to the capex governance arrangement to relate primarily to how the CAA's proposals might be applied

in practice, given how they might relate to the CAA's capex incentive proposals (our assessment of which is summarised below). We noted, in particular, that NERL pointed to its support for strengthening the role of the Independent Reviewer, but raised concerns over lack of clarity with respect to its remit and accountability in a context where its assessments could have material impacts. Our provisional conclusion is that the capex governance proposals included in its Decision, that strengthen the Independent Reviewer role and require quarterly SIP updates, should be applied.

33. The CAA Decision introduced three separate capex incentives: a) an efficiency incentive; b) a capex delivery incentive, and c) an information incentive.
34. As regards the efficiency incentive, we consider that the CAA Decision implies that the basis upon which the CAA would consider RAB disallowances following ex-post efficiency reviews has changed materially. However, the CAA has not codified the basis upon which it may apply a RAB disallowance to a sufficient degree, or in a sufficiently constrained manner. We consider that the scope for ex-post RAB disallowances inevitably creates a degree of regulatory uncertainty that can have adverse effects on investment incentives. This implies that particular care is typically merited when ex-post RAB disallowance arrangements are being developed or modified.
35. A licence condition that appropriately constrains the circumstances under which it might be reasonable for the CAA to disallow capex from NERL's RAB could help in addressing these concerns. However, we consider that introducing such a licence condition may not be necessary if the CAA developed a policy statement that sufficiently specified and constrained the basis upon which it would be expected to apply a disallowance of capex, following an ex-post efficiency review. We invite submissions from the Parties on what such a policy statement should contain in order to address the limitations we have identified.
36. We provisionally conclude that the capex delivery incentive in the form proposed by the CAA would result in NERL's facing undesirable additional risks associated with uncertainty over the regulatory treatment of capex that may be captured by it. We consider that the CAA provided little clarity over how its proposed capex delivery incentive might be applied, and little guidance that might assist NERL manage the risk that it may become subject to a penalty (which could amount to the total notional equity return allowed for on NERL's planned capital programme). We considered the CAA's own comments to illustrate some of the materially different ways in which its proposed delivery incentive might be interpreted and applied, if introduced.

37. We consider that a capex delivery incentive based on the quality of NERL's engagement, and its actions related to that engagement, should be introduced, providing there was appropriate specification concerning the criteria against which the NERL's performance would be assessed, and the basis upon which the level of any penalty to be applied would be determined. We have provided our initial views on an appropriate starting point for the development of such specification and invite submissions on how these arrangements might be developed.
38. Last, we provisionally conclude that the CAA's proposed information incentive should not be introduced in RP3. We consider that any capex that may result in NERL exceeding the level provided for by its RP3 allowance should be assessed within the capex delivery incentive (amended in the manner described above), and not subject to separate incentive arrangements.

Non-regulated income

39. As well as its main air navigation service business covered by its Licence responsibilities, NERL undertakes commercial activities with a 'single till' approach where the price control assumes that a portion of NERL's overall costs are funded through non-regulated income. NERL anticipates a reduction in revenue for RP3, with associated cost reduction for non-regulated activities compared with RP2, but with many of these resources being redeployed into regulated activities. The Parties have agreed that the total non-regulated revenue for RP3 should be £446 million.
40. The CAA proposed that NERL should make additional reductions to opex of £24 million in RP3 to represent a reduction in costs previously associated with lost non-regulated revenue.
41. We provisionally conclude that no additional reduction should be made in the Determined Cost allowance for RP3 for non-regulated activities beyond that included in NERL's RBP, as we consider the appropriate efficiency reduction has already been applied to opex.

Pensions

42. NERL operates both a defined benefit (DB) pension scheme (closed to new members) and a defined contribution (DC) scheme. The DB scheme currently has a deficit and the Trustees have advised on the level of repair costs needed to manage this. The DC scheme is based on a contribution rate of around 15%. A pension pass-through mechanism exists for certain pension cost changes that are non-controllable and efficiently incurred, but the Parties disagree on the interpretation of the requirements to apply this.

43. The CAA made some 'efficiency' adjustments to NERL's pension costs projections, including £18 million for deficit repair payments and £6 million for ongoing pension costs (resulting from opex savings in the CAA Decision). The total allowance for pensions in the RP3 Decision is £392 million.
44. We provisionally conclude that pension efficiency adjustments of £21 million could be introduced, given that the pension pass-through arrangements offered protection if efficiently incurred pension costs were above the upfront allowances (due to changes in market conditions), and that the size of the efficiency adjustment of ongoing pension costs is consistent with our position on opex (ie allowing for the difference in our opex allowance compared to the CAA Decision). However, we recommend that the CAA produces improved guidance to clarify the pass-through provisions that apply, showing circumstances when determinations of future costs would and would not be subject to pass-through. The Regulatory Policy Statement (RPS) represents an opportunity for this clarification to be made, allowing the upfront pension allowance to adequately address the effects adverse to the public interest identified in response to the CAA's first question.

Oceanic

45. The Oceanic charge is imposed on North Atlantic flights and is subject to a separate charge control condition in the licence. NERL is introducing a space-based automatic dependent surveillance (ADS-B) system in RP3 to provide more accurate and timely aircraft position information for lights crossing the North Atlantic, resulting in a large increase in the price charged to users. The CAA proposed an independent review of the benefits of this service after two years, which may influence the regulatory allowance for this new Oceanic service in the final two years of the RP3 price control.
46. In its Decision, the CAA proposed a 5% 'efficiency' reduction to the ADS-B data charge paid by the airlines, to encourage more robust negotiations with the ADS-B service provider, and an 'efficiency' reduction to opex associated with the Oceanic service for each year in the price control. Overall the CAA Decision included allowances for £211 million associated with Oceanic services, which was £12 million less than in NERL's RBP.
47. We considered representations from airlines and their trade body, IATA, concerning these and wider issues concerning the Oceanic service, as well as representations from the Parties. We provisionally agreed with most of the CAA's approach to the Oceanic services, including its decision to fund the costs of ADS-B, subject to a two-year independent review. We have however provisionally proposed an adjustment, to disapply the 5% efficiency reduction made by the CAA to the ADS-B data charge, as we concluded that the scale

of the reduction was arbitrary and there was no evidence that it was achievable.

Cost of Capital

48. We received detailed representations from the Parties and third parties containing a range of views on the appropriate approach to calculate the costs of capital for NERL.
49. In this case, we have performed our own determination of the cost of capital. We started with the framework used by the CAA and NERL – the CAPM – which is commonly used in regulated sectors. We took a fresh look at each of the parameters (including the total market return, risk free rate, betas and the cost of debt), although this was done by building on the data provided by the Parties and determining our own methodology to interpret that data. In some cases, we measured alternative ways to calculate those parameters, and included additional and more up-to-date information in our assessment. We came to provisional views on suitable ranges of each parameter of the cost of capital. In particular, we have assumed a higher range for the asset beta than that assumed by the CAA.
50. We provisionally decided that it would be appropriate to assume a notional gearing of 30% and calculated a suitable range for NERL's cost of capital of 2.39% to 3.73%, compared with 2.68% in the CAA Decision and 4.21% suggested by NERL.
51. Our provisional view is that the reason for choosing ranges is that there is a fundamental uncertainty about the level of the individual parameters. We agree with the CAA that it is appropriate for a regulator to exercise judgement in choosing the WACC from the range. We have therefore provisionally decided to choose a point estimate of the WACC from this range.
52. In coming to a point estimate, we have considered the risks of setting the WACC in the top or the bottom estimate of the range. We considered possible reasons for departing from the mid-point of the range (ie whether to aim up or aim down). We provisionally concluded on balance that there was no compelling reason in this case to deviate from the mid-point of our range.
53. We therefore provisionally conclude that the modification proposed in the CAA's decision set the cost of capital below a level which properly balances its objectives in determining NERL's assumed return. Our assessment of the cost of capital to use for NERL's price control for RP3 is 3.08% vanilla, which is the mid-point of our range for the cost of capital.

Overall assessment of the price control

54. Having investigated each element of the price control in dispute, we ‘stood back’ from the individual elements to consider the effect of our provisional conclusions on the price control in its entirety. We are satisfied that it would be against the public interest if there were no operative price control conditions in NERL’s licence, that the price control we have provisionally proposed is balanced, that there are no conflicting incentives, and that the modifications set out in our report would remedy the effects adverse to the public interest.

Next steps

55. We invite representations from the main parties and third parties on our provisional findings, and on how we should take account of the impact of Covid-19 in our Final Determination, to be received by 15 April 2020. The special reference group will then consider any additional evidence before making its final determination. The statutory deadline for sending our report on the reference questions to the CAA is 18 May 2020.