

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

15th April 2020

Dear Ms Ross,

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

Thank you for sharing the CMA's provisional findings report of the NATS En-route Limited (NERL) regulatory appeal. As an interested party IAG would like to make the following observations regarding:

- the provisional findings;
- the proposed adjustments; and
- how the CMA should take account of the impact of Covid-19 in its Final Determination.

The provisional findings

IAG broadly welcomes the positions taken by the CMA on the main regulatory building blocks of the price control, subject to the proposed adjustments for material known changes set out below. We note that the CMA has upheld the CAA's final price control decision in respect of both operating costs and capital expenditure allowances.

Although the CMA has provisionally determined a slightly higher weighted average cost of capital estimate at 3.08% (as opposed to the CAA's final decision of 2.68%), we note that the CAA's figure fell well inside the overall range determined by the CMA - unlike NERL's high estimate of 4.21%, which fell well outside.

We understand that CEPA, building on work it has previously completed as part of the RP3 price control determination process, plans to respond to your provisional determination on the specific question of NERL's weighted average cost of capital. CEPA will argue that the difference between the CMA's proposed range and the range it had suggested is not only attributable to a difference in judgement. It will say that in reaching its provisional conclusion, the CMA has drawn on an inconsistent interpretation

of the evidence that it has selected – and that there are two particular sources of inconsistency.

1. The CMA attaches very different weights to two imperfect but informative comparator groups; however, does not attach any weight to UK regulated utilities. It effectively attaches the vast majority of weight in its analysis to beta measurements from international airport groups. This approach does not reflect the CMA's own proposals to utilise evidence from comparators.
2. The CMA views ENAV's exposure to risk as being lower than that of NERL, based partly on an assumption that NERL has higher operating leverage than ENAV; however, it does not present evidence on operating leverage to support this assessment.

IAG is otherwise supportive of the CMA's proposed ranges on other parameters and its provisional conclusion that the CAA's proposed pension efficiency adjustments can be introduced.

We note the CMA's provisional finding that the Oceanic ADS-B data charge 5% efficiency reduction should be disappplied.

We also note the CMA's provisional finding that NERL should not be expected to make cuts of £24m in RP3 to costs previously associated with reduced non-regulated revenue, as was originally determined by the CAA. Our sense remains (as per our previous submissions) that that initial CAA Decision was '*generous*'. In response to your provisional findings, we hope that the CAA will provide further insight into its approach to OPEX - and that this will be taken into account by the CMA, in reaching a final determination.

The CMA's provisional findings endorse the CAA's overall approach to introducing CAPEX governance principles and incentives, for which we have also argued – not least, in light of our experience over the RP2 period, which saw significant changes, both to the scope and to the scale of NERL's CAPEX and wider investment programmes. We therefore welcome the CMA's position in relation to the principle of applying capital governance incentives to NERL in the RP3 price control period.

The CMA questions whether the CAA's proposed approach to ex-post efficiency reviews in relation to potential RAB disallowances represents a material change that increases regulatory risk. In our experience, the CAA is very reluctant to disallow expenditure from the RAB of the companies that it regulates; indeed, the CMA notes that the CAA states that only two disallowances have been made at Heathrow in 20 years! So even with this new approach, we do not anticipate any material increase in regulatory risk.

We note the CMA's question as to whether the CAA had considered introducing a '*Demonstrably Inefficient or Wasteful Expenditure (DIWE)*' test. IAG (and we believe all affected airlines) would support an effective process for disallowing inefficient expenditure, which has been assumed as part of previous price control determinations - and so informed risk allowances. We believe that the CMA should support the CAA in strengthening such

incentives and we would be happy to work with the CAA and NERL to help further develop these ideas.

Additionally, we anticipate working with the CAA and NERL to agree more detailed capital governance arrangements for RP3 in line with the CMA's determination.

Proposed adjustments

We believe that the CMA should look at additional adjustments, where there are clearly defined material changes, which could protect consumers from costs of investments that are no longer required within the RP3 period:

- the '*TC Foursight*' programme will now not be undertaken within RP3 and so capital provision for this specific investment should be removed;
- Heathrow's third runway delay (minimum two years) and potential cancellation will result in the OPEX provision for additional ATCOs required to support development and training no longer being needed; and
- the timeline for '*South-East Airspace Modernisation*' should be checked to ensure that the pace of RP3 airspace investment is aligned with the latest ACOG plans in the RP3 period - and if projects or allowances are no longer either fully or partially required these should be removed or adjusted.

COVID-19 impacts

IAG does not believe that the CMA should take account of the ongoing COVID-19 crisis as part of its final determination of this regulatory appeal. The full impacts of COVID-19 remain uncertain and will remain so beyond the time when the CMA will make its final determination. The aviation sector is unlikely to understand the full impacts until 2021 at the earliest.

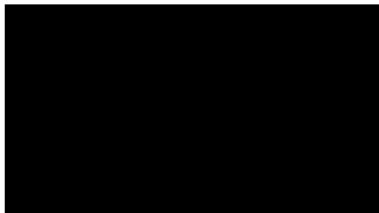
Notwithstanding the ongoing nature of the COVID-19 crisis, we are concerned that opening specific elements of the price control could lead to the entire price control being re-opened - and that this would not serve consumers' interests. The NATS' reference was made on specific grounds and we firmly believe the CMA should make a final determination based solely on those relevant points.

IAG believes that the CMA should use, as the basis of its final determination, the STATFOR forecast that was last published prior to the suppression of air traffic volumes in Europe due to COVID-19. There are well-established traffic risk-sharing mechanisms, which were created specifically and precisely to address these types of externalities. It would be perverse to abandon these mechanisms for dealing with a shock to the market when a shock occurs.

It is possible that the EC will take action in regard to reviewing how traffic risk sharing mechanisms should work as a response to the COVID-19 crisis, in response to industry calls for relief from a situation in which airlines (in particular) have been impacted by governments' decisions to impose travel restrictions. Airlines using UK airspace should not be put at a disadvantage to European competitors, by virtue of a CMA decision to use a COVID-19 impacted traffic forecast.

NERL, the CAA and airlines will be able to address the impacts of COVID-19 during RP3 using the consultative processes that are in place for the management of change. Whilst COVID-19 is not a *'business as usual'* event, our experience over the course of RP2 illustrates that significant change and adaptation to new circumstances can be managed between all parties, to ensure best outcomes for consumers. We would encourage the CMA to allow the CAA, NERL and airlines to work together to address COVID-19 over the coming months.

Yours sincerely,



Ian Clayton
Group Head of Regulatory Affairs