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NATS

NATS (En Route) plc

NERL Response to Provisional Findings – 24 April 2020

RP3 Reference: NERL031



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1. Foreword

1.1. Foreword by Martin Rolfe, CEO

We thank the CMA for their provisional findings (PFs), which provide useful guidance to the CAA and NERL in the key areas of dispute that have been raised during this redetermination process. We consider that the CMA's PFs offer a clearer and better balanced price control overall for NERL during RP3 (2020-2024) than the CAA's RP3 Decision.

Since the beginning of this year, all of our lives have been profoundly affected by the coronavirus disease 2019 (COVID-19). Only a few months ago, none of us could have imagined how differently we would be living now.

As a sector, COVID-19 has had a dramatic impact on aviation. NERL's RP3 Business Plan and the CAA's RP3 Decision are no longer relevant in the immediate or foreseeable future. The goalposts for NERL's RP3 reference have moved and one of the key challenges for the industry is the current uncertainty about what our future looks like.

NERL is focused on responding to the challenges created by COVID-19 in the best way possible to support our customers and the aviation sector more widely. I continue to be impressed with the pride, professionalism and passion of my colleagues as they rise to this new challenge.

Given the other immediate priorities of the aviation sector, we have prepared this response on the basis that we will use these PFs as guidance and the CAA will be requesting clarification of the CMA in only minimal areas about how you have reached your preliminary conclusions. Our request of the CAA and CMA is to facilitate the prompt and efficient conclusion of all elements of the reference that might otherwise require the CMA to do further work on estimating costs or prices for NERL in RP3 in order to reach a Final Determination. However, we reserve the right to make further submissions to the CMA to the extent that the CAA provides any new material that disputes your PFs.

2. Introduction

2.1. Background to NERL RP3 Reference

- 1 Last autumn, NERL rejected the CAA's RP3 Decision for its price control for Reference Period 3 (RP3), which led to this reference to the CMA. We did so because we considered that the CAA's RP3 decision was not in the public interest because it would not have enabled us to deliver the service quality nor technology transformation and airspace modernisation that was needed by the aviation industry.
- 2 Until overtaken by events associated with COVID-19, this reference was the priority for NERL's Executive team and Board. We fully engaged with this process, including providing:
 - three formal submissions that were individually in excess of hundreds of pages
 - supporting evidence that ran into hundreds of documents; and
 - full-day site visits and hearings, attended by the Executive team.
- 3 However, since mid-March 2020, as a result of the impact of COVID-19 on daily lives, as well as our commercial activities, we have had to switch our focus to the safety of our staff, adapting our operational service and ensuring the future financeability of the business. It is no exaggeration to say that NERL's long-term business model is at risk, along with many other businesses in the aviation sector.

2.2. COVID-19

- 4 The World Health Organisation was first informed about a new virus with pneumonia characteristics in Wuhan City, Hubei Province of China on 31 December 2019, COVID-19¹. Along with other interventions, the Chinese authorities acted to reduce transmission of the virus by preventing residents of Wuhan from leaving the area through a "lockdown".
- 5 At first, the international community were optimistic that COVID-19 could be confined locally. However, COVID-19 began to quickly spread across the world, with countries initiating their own lockdowns to limit transmission, which significantly reduced domestic and international travel. On 11 March 2020, the US shut its borders to the majority of EU citizens², which affected the UK on 16 March 2020³ and was followed by the EU shutting its borders on 17 March 2020⁴. According to the Pew Research Centre, nine out of ten people are living in countries with travel restrictions due to COVID-19⁵. This has led to a

¹ World Health Organisation 2020, *Novel Coronavirus (2019-nCoV) Situation Report - 21 January 2020*, https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200121-sitrep-1-2019-ncov.pdf?sfvrsn=20a99c10_4, (accessed 21 April 2020)

² National Archives 2020, *Suspension of Entry as Immigrants and Nonimmigrants of Certain Additional Persons Who Pose a Risk of Transmitting 2019 Novel Coronavirus*, <https://www.federalregister.gov/documents/2020/03/16/2020-05578/suspension-of-entry-as-immigrants-and-nonimmigrants-of-certain-additional-persons-who-pose-a-risk-of> (accessed 21 April)

³ National Archives 2020, <https://www.federalregister.gov/documents/2020/03/18/2020-05797/suspension-of-entry-as-immigrants-and-nonimmigrants-of-certain-additional-persons-who-pose-a-risk-of> (accessed 24 April)

⁴ Eurocontrol 2020, *State and Airline Response to COVID-19: 17 April 2020*, https://www.eurocontrol.int/sites/default/files/2020-04/eurocontrol-summary-covid-response-17042020_0.pdf (accessed 21 April 2020)

⁵ Pew Research Centre 2020, *More than nine-in-ten people worldwide live in countries with travel restrictions amid COVID-19*, <https://www.pewresearch.org/fact-tank/2020/04/01/more-than-nine-in-ten-people-worldwide-live-in-countries-with-travel-restrictions-amid-covid-19/> (accessed 22 April 2020)

highly material reduction in traffic levels that looks likely to fundamentally reshape the aviation sector over the short to medium term.

3. NERL response to the CMA PFs

3.1. Summary

- 6 NERL welcomes the CMA's PFs and thanks the CMA Panel members and their team for their effort in producing them.
- 7 We fully engaged in the process and it is clear in the PFs that the CMA staff have understood our concerns and the evidence we presented. This does not mean that we have been successful in “winning” our arguments in all the areas of dispute with the CAA. In particular, we find that where judgement from the CAA was required to reach a Decision, on balance the CMA has agreed with the CAA. Nonetheless, we are content with the CMA's PFs because they provide a clearer and more balanced price control for NERL than the CAA's RP3 decision.
- 8 We do not believe that there is enough certainty about the impact of COVID-19 on the aviation industry to enable the CMA to refine any numbers in its PFs into a Final Determination for this reference, either now nor in six months' time, the latter being the maximum extension available. This practical challenge, and other critical priorities for us, our industry and the UK government at this time, means that we are requesting the CMA reaches its final conclusions for this reference as efficiently and quickly as possible, subject only to final clarification of the remaining issues that have been requested from the CAA. This is on the understanding that NERL's RP3 business plan will need to be significantly revised later on in light of COVID-19.

3.2. Structure of document

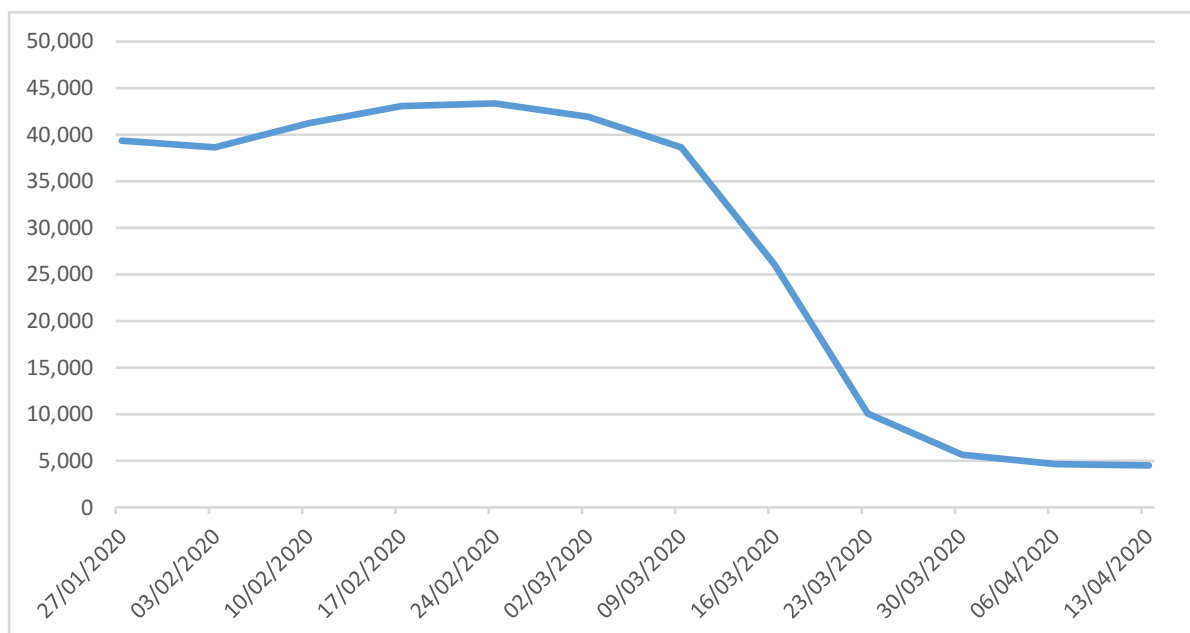
- 9 The structure of the rest of the document is as follows:
- background and context to our response to the CMA's PFs (see Section 4); and
 - feedback on the principles in the CMA's PFs according to the building blocks of the price control (see Section 5)

4. Background and context to NERL's response to the CMA's PFs

4.1. COVID-19 traffic downturn

10 As stated above, COVID-19 has had a dramatic impact on aviation traffic. On Sunday 19 April 2020, there was a 91.2% reduction in European flights and a 93% reduction in UK flights compared to one year ago⁶. Since the end of March 2020, UK traffic has consistently been around 90% lower than a year ago, with indications that this will continue until at least May 2020.

UK flights by week, January-April 2020



Source: NERL analysis

11 While the volume of traffic is significantly reduced, that which remains is still vital to the UK economy and the people living here. Therefore it remains essential that NERL continues to provide a safe and uninterrupted service, which we have been doing. The majority of the remaining traffic is cargo, including essential medical supplies. DHL Express is operating the most flights in the UK and has almost doubled its volume with a 92% increase, compared to the same time last year⁷.

4.2. Aviation outlook uncertain but different

12 There are various scenarios about how long the downturn in flights will last, the speed of recovery and what the 'new normal' will look like following inevitable change. Common themes include the current low traffic levels continuing for months and traffic remaining

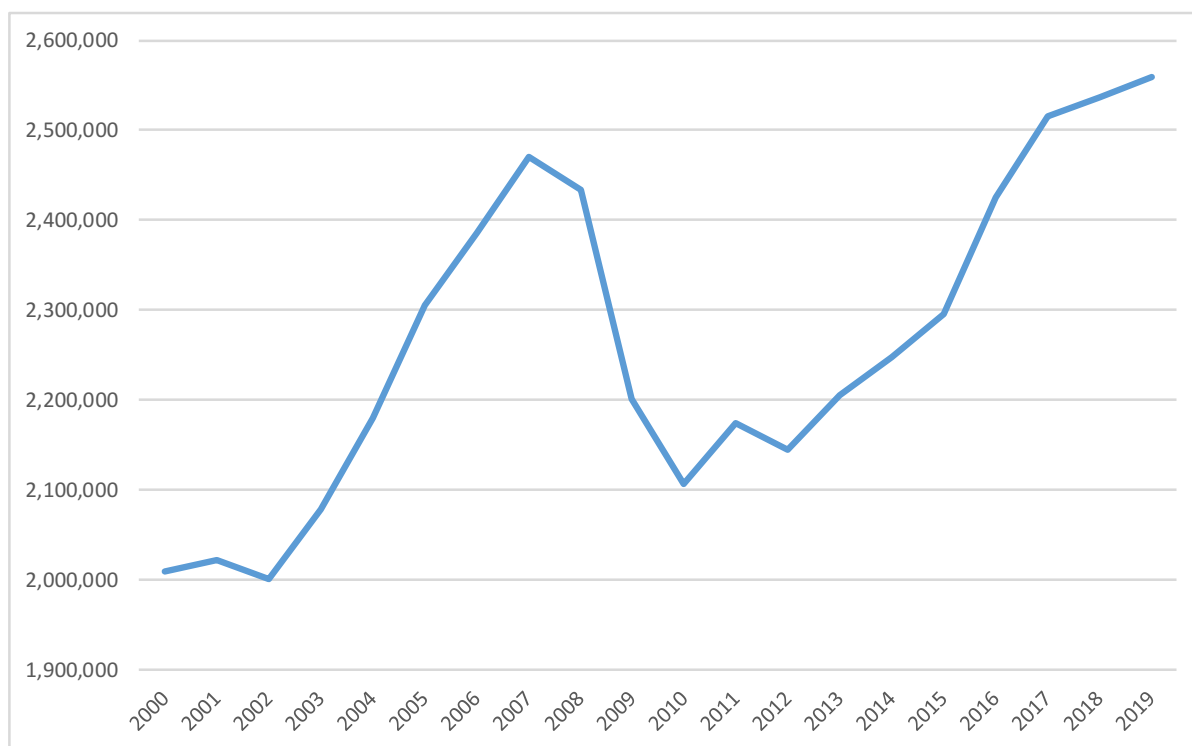
⁶ Eurocontrol 2020, COVID19 Impact on European Air Traffic: EUROCONTROL Comprehensive Assessment, <https://www.eurocontrol.int/sites/default/files/2020-04/covid19-eurocontrol-comprehensive-air-traffic-assessment-20042020.pdf> (accessed 21 April 2020), pp.1-2.

⁷ NATS 2020, *Daily performance report: 19/4/20*, p. 4

below previous levels for the foreseeable future. What is clear at this stage is that no one currently knows what the future holds: airlines, airports or industry bodies.

- 13 It is possible that the impact of COVID-19 on aviation could extend beyond the duration of the pandemic due to the likelihood of a recession as well as lower appetite for travel in the future⁸. There has been a strong relationship between GDP and air travel historically. It is possible that aviation could be further impacted by changes in ongoing behaviour, such as businesses only requiring employees to travel for work when absolutely essential, with greater acceptance and mass use of video communication technology.
- 14 Airlines are beginning to permanently reduce their medium-term capacity instead of moth-balling their aircraft ready for future redeployment⁹. This supports predictions of there being at least a medium-term reduction in air travel.
- 15 Similar to the current situation itself, the magnitude and duration of the subsequent disruption to the aviation sector from COVID-19 could be unprecedented¹⁰. Only the 2008 global financial recession comes close to initial estimates of impact¹¹. Following the reduction in travel experienced in 2008/09, it took ten years for UK traffic to return to its previous record-breaking levels (see Graph 2 below - 2018 from 2008).

Graph 2: UK annual air traffic movements, 2000-2018



Source: NERL analysis

⁸ European Commission 2020, European Commission (2020), *Annexes to Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Investment Bank and the Eurogroup. Coordinated economic response to the COVID-19 Outbreak*, COM(2020) 112 final, 13 March, Annex 1, https://ec.europa.eu/info/sites/info/files/communication-coordinated-economic-response-covid19-march-2020_en.pdf (accessed 14 April 2020)

⁹ Financial Times 2020, *Lufthansa decommissions 40 jets and axes Germanwings*, <https://www.ft.com/content/48fcd03c-3043-4485-a1e7-c7c07cebe444> (accessed 8 April 2020) and easyJet 2020, *easyJet RNS Statement - Aircraft Delivery Update*, <http://otp.investis.com/clients/uk/easyjet1/rns/regulatory-story.aspx?cid=2&newsid=1385435> (accessed 14 April 2020)

¹⁰ ACI 2010, *Unprecedented impact of pandemic on European airports clear as March passenger numbers are released*, <https://www.aci-europe.org/downloads/mediaroom/20-04-09%20Unprecedented%20impact%20of%20pandemic%20on%20European%20airports%20clear%20as%20March%20passenger%20numbers%20are%20released%20PRESS%20RELEASE.pdf> (accessed 14 April 2020)

¹¹ Helios 2020, *COVID-19 and aviation: planning for the 'new normal'*, <http://www.askhelios.com/blog/covid-19-and-aviation-planning-for-the-new-normal> (accessed 9 April 2020)

4.3. Impact on NERL, including mitigating actions

16 NERL has been focused on responding to the impact of COVID-19 on the aviation industry. In the past six weeks, it has had a significant impact on how we are running our operation, financing our business and planning our investment.

4.3.2. Operational impacts

17 NERL's priority is protecting its staff and continuing to provide a service that is essential to the UK economy. In addition to cargo traffic, we are continuing to ensure that flights remain safe for the military, air ambulance and police. We are achieving this by:

- taking advantage of the low daytime traffic volumes to support social distancing with ATCOs managing on similar staffing levels to night time operations. Less than a third of the usual number of ATCOs are "on duty" or physically working in the operation with another quarter available for contingency, especially in the event of illness.
- delivering the same services differently where it is possible to do so as a short term measure e.g. the Flight Information Service¹²; and
- suspending services that are not required during the UK's lock-down i.e. Airspace User Portal for drones¹³.

18 In addition to adapting our services, we are also having to take steps to ensure that those staff required to be at the workplace to deliver the essential tasks associated with air traffic control receive all the proper protections for their own health.

4.3.3. Financial impact

19 Apart from the safety of our staff and of aircraft that continue to fly, NERL's focus has been on its liquidity and ensuring that it remains financeable. The dramatic reduction in traffic has had a significant effect on our current cashflow, where every flight not flown represents a loss of immediate revenue. At the beginning of March, given inherent uncertainty, we created a scenario based on possible traffic volumes which, if it came to fruition without further mitigation, indicated NERL might only have had seven months of liquidity. The mitigating actions below have extended our liquidity in that possible scenario:

- external recruitment freeze
- deferral of bonuses and pay awards for all staff
- voluntary pay reduction by the Board, Executive team and senior management grades
- furloughing of almost half of our staff
- immediate freeze on non-essential expenditure
- termination of most external contractors
- seeking agreement for extended payment terms with suppliers

¹² Juliet Kennedy 2020, *Government restrictions and staff safety during COVID-19 related to Western Radar and Farnborough Lower Airspace Radar Service*, Letter to Jon Round, 26 March

¹³ NATS 2020, *Non-Standard Flight applications*, <https://www.nats.aero/do-it-online/non-standard-flight-nsf-applications/> (accessed 21 April 2014)

- deferral of monthly PAYE and National Insurance Contributions payments to HMRC; and
- Changes to our investment plan – see 4.3.4 below.

20 Additional items that are currently supporting these efforts, or being explored further in relation to our current challenges, include:

- securing free cash availability through increased borrowing due to the flexibility created by our relatively low gearing: £400m of bank facilities were fully drawn down at 31 March 2020
- additional credit lines being discussed with banks
- review of NERL's eligibility for the government's COVID Corporate Financing Facility
- input to proposals put forward by Eurocontrol to Member States, to defer airline charges while seeking funding for up to 51% of ATC revenue allowances; and
- potential for deferral of defined benefit pension scheme contributions

21 These actions and a number of important assumptions, such as the robustness of the current regulatory cost recovery mechanisms and that airlines continue to deliver against their obligations under these, allow us to conclude for the time being that there is no likely prospect of insolvency. However, we are constantly monitoring the assumptions relating to our scenario as further insight and intelligence comes to the fore in order to assess whether further actions are necessary.

4.3.4. Investment plan impact

22 Our immediate response on our investment plan has been driven by the need to provide liquidity to the NERL business. We have deferred everything apart from:

- essential sustainment (operational systems, facilities management and business IT); and
- completing technology transformation already started that cannot be stopped for technological and/or cost efficiency reasons (DP En Route and Voice).

23 Based upon our initial planning, these changes will extend the delivery timescale for DP En Route by 12 - 18 months. While we are looking at opportunities to mitigate delays wherever possible to do so, the complex dependencies and requirements across the portfolio will mean there is significant impact to the remaining programmes, the scale and nature of which are being assessed. However, with the new constraints and prevailing economic challenges for the airline industry, we have to consider a very different capital investment plan to reflect the new circumstances.

24 As the CMA will appreciate having reviewed our investment plans in detail, these are drastic steps for NERL but, in the circumstances, are an unavoidable ones.

4.4. Infeasibility of resetting a price control now

25 Given the impact of COVID-19 on current and future flights, existing RP3 plans for NERL are no longer reflective of the underlying operational circumstances. These include:

- the business plan NERL created for RP3 in October 2018; and
- the CAA's RP3 Decision published in August 2019, which is the focus of the CMA's reference.

- 26 As the CMA itself acknowledged in the PFs, those too reflect operating conditions prior to COVID-19¹⁴.
- 27 Traffic forecasts are either unavailable or are much more likely to be wrong than normal. STATFOR has not released its March 2020 forecast. Projections that are available rely on a "scenario" approach, given the inability to utilise solid assumptions for forecasting purposes, and have a significantly wider range of outcomes. We have particular concerns about the ability of STATFOR's modelling to adapt to new patterns of traffic flows, particularly with respect to Oceanic volumes.
- 28 A price control reset does not work in the current situation, either from a planning or mechanical point of view due to the degree and severity of uncertainty that impacts the entirety of our operations. Any attempt to set one now would be misguided and would inevitably create tensions with respect to the satisfaction of the statutory duties under the *Transport Act 2000*.

4.5. Next steps

- 29 The CMA's PFs (supplemented where applicable by further work to conclude on the Final Determination) will provide an anchor of principles in key areas that were in dispute between the CAA and NERL such as capex governance, WACC, Aireon charges and non-regulated income. We welcome the views expressed by the CMA in these areas which we consider contribute to a better and more balanced view of the price control that NERL should be subject to. This guidance from the CMA can be used by the CAA when it becomes a viable option to reset NERL's price control.
- 30 It is unlikely that there will be enough certainty about future traffic to reset NERL's price control during 2020. However, there might be enough certainty at some point in 2021 to allow NERL's price control to be reset in 2022. It could be set for three or five years, depending on what is appropriate, including any applicable direction under EU law, assuming that NERL remains subject to EU law following Brexit negotiations.
- 31 In advance of such a formal reset, NERL will need to consult its customers and reach an in principle agreement with the CAA on an interim plan that takes into account, in the context of the COVID-19 pandemic:
- The steps NERL's management team is currently taking to protect the business and provide a service to significantly reduced air traffic
 - what is the right size and cost of NERL's business, as projected aviation demand becomes clearer; and
 - the financeability of the NERL business.

¹⁴ CMA 2020, NATS (En Route) Plc / CAA Regulatory Appeal: Provisional findings report, https://assets.publishing.service.gov.uk/media/5e7a2644d3bf7f52f7c871f3/Provisional_Findings_Report_-_NATS_-_CAA.pdf (accessed 24 April 2020), p. 2.

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- 32 It is therefore our expectation that the interim arrangements in place until the price control is reset, will take the CMA's Final Determination and turn them into new Licence Conditions for NERL. The resulting price control settlement will then form a new baseline from which an interim plan and ultimately a reset of RP3 can be assessed.
- 33 It will be vital for NERL to engage with its customers and the CAA about the steps it is taking immediately, in the medium-term and longer-term to deal with COVID-19. We consider the bi-annual Service and Investment Plan (SIP) meetings would be an appropriate vehicle for the interim arrangements. NERL is planning to explain to customers what it has done immediately and to engage with them in discussions about the available options through its interim SIP (May 2020) with further capex planning in the final SIP this year (October 2020). This will need to be followed by more customer engagement (Customer Consultation) in 2021 for a new price control in 2022.

5. NERL feedback on principles in CMA PFs

5.1. Service quality and 3Di

34 In reaching its provisional conclusion to make no change to the targets or metrics in the CAA's RP3 Decision, we are disappointed that the CMA did not prioritise our arguments about the importance of consistency with better regulation principles in this area. However, the targets for service quality and 3Di will need to be revised significantly in light of COVID-19.

5.2. Traffic

35 We understand the rationale in the CMA's provisional conclusion to use the latest STATFOR forecast available for its Final Determination. However, a practical challenge for any update is that STATFOR has been unable to release its March update and it is not yet clear when it will be able to provide new, reliable forecasts. Traffic recovery is likely to be influenced for some time by public health considerations and interventions, which is impossible to predict now. Any updated STATFOR forecast will need to be sense-checked against our knowledge of local circumstances that are specific to NERL, such as the transatlantic character of much of NERL's traffic, compared with the STATFOR norms.

36 We would prefer the CMA to use STATFOR's Feb-19 forecast in its Final Findings, rather than STATFOR's Sep-19 forecast. This is because the Feb-19 forecast is lower, and will support NERL's cashflow, by helping us to partially mitigate the liquidity challenges we face as a result of significantly reduced traffic volumes.

5.3. Operating expenditure

37 We note the CMA's feedback about NERL's relative inflexibility and lack of scenario-planning provided in relation to operational expenditure.

5.4. Capital expenditure

38 We support the CMA's provisional conclusion that it was unreasonable for the CAA to expect NERL to deliver the same scope of its original investment programme but for less money without any analysis or substantive justification. This approach by the CAA was a significant factor in leading NERL to the position where this reference was required, given that the effect of the CAA's RP3 Decision was to restrict the operational and financial freedom of NERL's management to the extent that the CAA's RP3 Decision, as an overall package, was undeliverable.

5.5. Capex governance

39 We support the CMA's provisional conclusions for capex governance, including:

- *Efficiency incentive* – instead of the CAA's RP3 Decision, to include a 'Demonstrably Inefficient or Wasteful Expenditure' clause in the Licence, subject to clarifying what the expanded information criteria means through guidance (where we do not wish to overload the Licence with detail and or frequent changes)

- *Delivery incentive* – instead of the CAA’s RP3 Decision, the £36m at risk to be assessed against a delivery schedule using expanded information timeliness/quality/responsiveness criteria, where it is inappropriate to hold NERL to milestones in its Licence where there is no reliable basis for identifying and reflecting relevant changes in circumstances that might affect the delivery of a milestone
- *Information incentive* – removal of the CAA’s RP3 Decision due to duplication/overlap with the reframed delivery incentive.

5.6. Non-regulated income

40 We support the CMA’s provisional conclusion to reverse the CAA’s RP3 Decision on the premise that we demonstrated through the information exchanges that formed part of the reference process that we needed these costs to fulfil our Licence obligations. We will work on making our explanation and justifications in this area more clear and immediately understandable in any RP3 re-plan and RP4 preparations.

5.7. Pensions

41 We support the CMA’s provisional conclusion to stick with the CAA’s RP3 Decision subject to better clarity about pass through provisions to be provided through guidance. The CMA’s PFs reinforce the importance of the Regulatory Policy Statement to Trustees, which is very relevant in the current environment where COVID-19 has led to a fall in investment values.

5.8. Oceanic

42 We support the CMA’s provisional conclusion to remove the CAA’s application of a 5% efficiency adjustment to ADS-B data charges. We caution against any attempt to assess the cost-benefit case for ADS-B with the benefit of hindsight (post-COVID-19) instead of assessing whether NERL’s management took reasonable actions given the circumstances at the time (during NERL’s RP3 planning). This is especially relevant given the impact of COVID19 on flight volumes and fuel prices. Practically, this might mean that any assessment has to happen later or be restricted to elements that remain relevant such as safety.

5.9. WACC

43 We support the CMA’s provisional conclusions for WACC, including:

- asset beta: NERL more risky than the CAA assessed (as highlighted by the current COVID-19 situation, which has similarly affected big European airports and ENAV, more than other utilities) and market average of 1 not a cap (depending on our gearing)
- aiming up/middle/down: no reason not to aim for the middle and
- gearing 30%: “choice for NERL” and way of squaring a circle / intellectual conundrum

44 In terms of the asset beta, we welcome the approach adopted by the CMA, which brings this parameter into line with our estimate (0.57). In particular, the CMA has recognised that utilities are not a relevant comparator when estimating the cost of equity for NERL and that our regulated business is higher risk than ENAV, currently the only listed provider of air navigation services in Europe. We consider that these are important principles that

should underpin any future regulatory estimates of our asset beta. The CMA's use of large, publicly listed European airport operators as the closest comparators for NERL is consistent with the approach advocated by NERL and our advisers.

- 45 We note that, given the timescales of the redetermination, the cut-off date for the CMA's beta analysis precedes the substantial reduction in traffic that the aviation sector has experienced as a result of the COVID-19 pandemic. The impact that this has had on the aviation sector has exceeded that of the market as a whole and therefore we note that re-running the analysis would likely result in slightly higher beta estimates than captured in the PFs.
- 46 We further note the CMA's finding that it is plausible that NERL could have an equity beta of greater than one at higher levels of gearing. It is important that the market average beta of 1 is not considered to be a 'cap' if the evidence points to a higher equity beta in the future.
- 47 We note the CMA's finding that the cost of capital estimate, using the standard CAPM approach, increases with the assumed level of gearing, which appears to be inconsistent with finance theory and corporate practice. We acknowledge the CMA's concerns that (absent other adjustments) this implies customers would end up overpaying if the notional gearing level is set above the company's actual gearing. The CAA's proposed approach is to use a gearing assumption of 30%, which is broadly in line with that of the beta comparators and NERL's 2018/19 gearing ratio as reported in our regulatory accounts. Importantly, the CMA makes clear that NERL retains the flexibility to increase its actual gearing beyond that level if it deems this to be efficient.
- 48 We consider that this approach is not unreasonable given the current evidence on the gearing levels of NERL and the beta comparators. However, we anticipate that this will need to be revisited for any future cost of capital determinations given our long-term financing strategy and the potential that the comparator companies revise their own capital structures (particularly in light of COVID-19). A gearing level of 30% is low relative to NERL's historical actual gearing and given our planned approach to financing the RP3 capital programme.
- 49 However, in relation to the total market return, we are disappointed with the CMA's approach of placing such limited weight on the historic ex post CMA-adjusted CED/RPI inflation series methodology. The CMA has adopted a range of 5.0% - 6.0% for total market return, where the mid-point of this range sits outside of the CMA's historic ex post CED/RPI inflation series approach (5.6% - 6.2%), and represents a significant change from the total market return at RP2 of 6.25%.

6. Index of Supporting Documents

Ref	Name
PFR1	Daily Performance Report 19_4_20
PFR2	Government restrictions and staff safety during COVID-19 related to Western Radar and Farnborough Lower Airspace Radar Service

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