

NATS (En Route) plc

NERL Additional Response to Provisional Findings – 11 May 2020

RP3 Reference: NERL032



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1. Background

- 1 NERL was broadly content with the CMA's provisional findings (PFs) because they gave us a clearer and better balanced price control overall than the CAA's RP3 Final Decision. This meant our feedback (NERL031) was focused on the principles behind the CMA's PFs¹. We did not restate our positions relating to the cost allowances because:
 - we were confident that the CMA understood the arguments, concerns and evidence we had previously presented;
 - new information related to Covid-19 is either highly uncertain or simply unavailable; and
 - therefore, it is not possible to refine the numbers in the PFs into a meaningful Final Determination (FD), including the tensions this would create for satisfying the requirements of the Transport Act.
- 2 Nonetheless, we reserved the right to make a further submission if the CAA provided new material that disputed the CMA's PFs.

¹ NERL 2020, NERL response to provisional findings – 24 April 2020, RP3 Reference: NERL031

2. Introduction

- 3 The CAA has disputed elements of the CMA's PFs in relation to non-regulated income, asset beta, operating expenditure and capital expenditure. However, none of the material submitted by the CAA has changed our previous evidence or views.
- 4 NERL has concerns about unintended consequences arising from the CAA's capex governance proposals in its response to the PFs, which we describe in this further submission. We take the opportunity to clarify NERL's position in relation to Oceanic ADS-B in response to a query posed by the CAA. We also comment on the ongoing importance of the regulatory mechanisms relating to pension cost pass through and traffic risk sharing.
- 5 We set out our concerns, clarifications and commentary in the rest of this document so that the CMA can take account of them in reaching its FD.

3. Pensions RPS

- 6 We were concerned that the CAA's response to the CMA's PFs could be interpreted as suggesting some delay in progressing the CAA's support for current pension pass-through arrangements through a RPS²:

"...The PFs state that we could provide such additional clarification through a regulatory policy statement (RPS) for pensions, as discussed in our final decisions.

We agree it would be helpful to publish these clarifications as part of an RPS and expect to consult stakeholders on the RPS before it is finalised.

In light of Covid-19, we recognise that an in-depth review of NERL's pensions costs may be necessary when there is a better understanding of the longer-term impact. We intend to address these matters as part of the re-opening of NERL's price control arrangements in 2021.

3.2. Background

- 7 As at 31 December 2018, the NATS group pension scheme had assets of £4.4 billion and liabilities of £4.9 billion³. Approximately 80% of its members sit within NERL⁴. However, NERL's RAB is worth less than £1 billion⁵. Given this, the regulatory treatment of pension costs is key for the CAAPS Trustee to assess the NATS covenant; connected assumptions help to ensure associated costs are minimised.

- 8 Since 2006, NERL has been able to pass through changes in pension costs to customers due to the high degree of uncertainty in the level of pension contributions as a result of factors beyond our control. This mechanism was adopted at the European level in 2012⁶.

3.3. Concern

- 9 The pension RPS is important because of the assurance it gives the CAAPS Trustee, which feeds into its triennial valuation assessment and ultimately the prices paid by passengers. This is particularly pertinent at the moment where Covid-19 has led to a fall in investment values and the CAAPS Trustee has agreed to contribution deferrals to help with our immediate liquidity challenge. Further discussions are ongoing with a view to potentially extending this deferral further. The Trustee made clear as part of that process that it continues to rely on the support of the regulatory mechanism in their assessment, being the pension cost pass through mechanism and the anticipated RPS.

² CAA 2020, *Reference to the CMA of NERL RP3 price control: CAA response to CMA's provisional findings: CAP 1910*, p. 8

³ NERL 2019, *Overview of Air Traffic Management Industry and NATS (En Route) plc for the CMA*, p. 39

⁴ NERL 2019, *Overview of Air Traffic Management Industry and NATS (En Route) plc for the CMA*, p. 38

⁵ NERL 2019, *NERL Regulatory Accounts 2018*, p. 9

⁶ NERL 2019, *Overview of Air Traffic Management Industry and NATS (En Route) plc for the CMA*, p. 39

3.4. Request

- 10 We request that the CAA is strongly encouraged to complete the relevant RPS before the autumn, to allow it to deliver its maximum benefit for passengers by being taken into account in the December 2020 triennial valuation.

4. Capex governance

- 11 NERL is committed to engaging constructively with our customers and the CAA on our capital expenditure activities and we welcome the opportunity for earlier and clearer feedback on our investment programme. However, the incentive arrangements for capex governance are still evolving and we are concerned that they may be applied retrospectively to any existing RP3 plans, instead of any RP3 re-plan. We also question whether the CAA's proposals for the engagement incentive are in the public interest.

4.2. Efficiency incentive

- 12 We welcome how the CAA has set out it will interpret the demonstrably inefficient and wasteful expenditure (DIWE) test⁷, which seems both sensible and pragmatic.

4.2.2. Concern

- 13 However, we are concerned about how the CAA might apply the factors that it has stated it will take into account in applying the DIWE test⁸. We believe it would be challenging to judge the following factors without the benefit of hindsight:

"...g) The extent to which any expenditure was increased by any avoidable delay on the part of NERL and/or its third-party contractors.

h) The extent to which any expenditure was proportionate to the outputs which that expenditure was intended to, and/or did, deliver..."

- 14 The CAA acknowledged themselves the risk of that hindsight judgement at the CMA hearing⁹.

4.2.3. Request

- 15 To provide checks and balances against this tendency, we request that the CAA:
- be guided by a "reasonable person test" based on information available at the time when applying DIWE; and
 - strengthen their advisory support in reaching these judgements by including in its guidance its commitment to tender the Independent Reviewer role to a firm through competitive tender, as indicated in its Response to our Statement of Case¹⁰ (instead of the current situation, as outlined in NERL014: our post hearing submission).

4.3. Engagement incentive

- 16 The CAA has, as requested by the CMA, set out further detail for consideration about how an engagement incentive could be implemented. It has drawn on the relevant example of the Electricity System Operator (ESO), which is also asset-light (compared to other

⁷ CAA 2020, Reference to the CMA of NERL RP3 price control: CAA response to CMA's provisional findings: CAP 1910, p. 16-17.

⁸ CAA 2020, Reference to the CMA of NERL RP3 price control: CAA response to CMA's provisional findings: CAP 1910, p. 17-18

⁹ CMA 2020, NERL/CAA regulatory appeal: provisional findings report, p. 89 and p. 91

¹⁰ CAA 2019, Reference to the CMA of NERL RP3 price controls: CAA response to NERL's Statement of Case, CAP 1870, , para 7.14, p. 69

utilities) and operates at the heart of the network. However, the CAA's proposal creates a significant extra regulatory burden on NERL and its customers that will not be matched by commensurate benefits, for the reasons described below.

4.3.2. Concern

17 We question whether aspects of the CAA's interpretation of the ESO regime:

- have been transferred appropriately to NERL; and
- meet the spirit of the CMA principles.

4.3.2.2. ESO regime transfer

18 We are concerned that the CAA has used only parts of the ESO regime, resulting in a more draconian arrangement than that in place for the ESO. The ESO is subject to a +/- £30m symmetrical arrangement. The CMA has encouraged the CAA to consider greater use of symmetry in the future but the CAA's proposal would impose only penalties on us. Under their proposal, the CAA also appears to mark our scores instead of the independent "Performance Panel" that is in place for the ESO¹¹.

19 NERL is a more complicated organisation than the ESO. Both organisations manage the day-to-day operation of a network that is part of the national infrastructure, perform a planning function and rely on IT infrastructure. However, NERL also has to manage a material number of physical assets and highly specialised labour. This suggests that the priority should be on simplifying engagement processes for customers rather than complicating them.

20 This challenge of engaging with complexity might be even greater for our airline customers than electricity generation and supply companies that rely on the ESO for their operation. The airline participants in the Service and Investment Plan (SIP) process tend to be generalists or senior stakeholders¹², which makes it difficult for them to have a deep knowledge or understanding of the intricacies of our business.

4.3.2.3. CMA principles

21 We question whether the CAA's application of the ESO engagement incentive regime to NERL meets the CMA principles for NERL's capex regime of user focus and proportionality.

22 In terms of user-focus, most airlines (and previously the CAA) wanted a higher-level report¹³, where the CAA's ESO proposal provides the opposite. Trax International's Independent Review of the SIP document, which was jointly commissioned by the CAA and NERL and drew on airline feedback in July 2019, directed NERL to create a simpler document that was more accessible to airlines¹⁴, whereas previous additions of detail had made it too complex¹⁵. Airlines also wanted targeted engagement through biannual SIPs

¹¹ Ofgem 2018, The Electricity System Operator Reporting and Incentive Arrangements: Guidance Document, p. 7

¹² Trax International 2019, Independent Review to support the SIP document: Final report, p. 14.

¹³ NERL 2019, *NERL Reply – 20/12/19: RP3 Reference NERL006*, p. 59 and Trax International 2019, Independent Review to support the SIP document: Final report, p. 8

¹⁴ Trax International 2019, Independent Review to support the SIP document: Final report, p. 17

¹⁵ Trax International 2019, Independent Review to support the SIP document: Final report,

and quarterly dashboards¹⁶, instead of the of continual engagement suggested by the language of “continuous updates”.

23 In terms of proportionality, we note the following:

- **Lack of objective assessment:** while the CAA has provided a lot of detail on scoring itself, the descriptors of the scores remain very broad so it is difficult for these to be objectively applied i.e. reaching assessment of poor versus average/“baseline” performance. This could be mitigated by the use of an independent panel of industry experts to be the “marker” of the scheme, as set out in the proposed “escalation process” from the summer 2018 consultation which NERL agreed with customers, and as used in the ESO engagement incentive.
- **Rapid penalty escalation:** the range at which maximum penalty is incurred in the CAA’s proposals is very narrow, with penalties applied immediately if performance falls below 3 and maximum reached at 2 and then magnified through a “penalty uplift”. We would suggest a “deadband” between 3 and 2, especially at the beginning of the regime, penalties applying between 2 and 1 and the “uplift” removed.
- **Uncertainty:** while the intent of this guidance was to reduce the uncertainty faced by NERL in the operation of a new capex governance regime, it has reintroduced uncertainty as the CAA has raised the possibility of an “in period adjustment”. It would reduce uncertainty if the CAA confirmed that the overarching approach would remain broadly the same within a price control period with only minor refinements. Flexibility could be achieved through a “deadband” approach instead, which was previously adopted when using new incentives like 3Di, and could be deployed between the scores 3 and 2 as noted above.
- **Inappropriate disaggregation:** the CAA’s approach is at a project-level, whereas NERL manages benefits at a programme level, in keeping with customer focus. The CAA’s approach of a greater degree of disaggregation will lead to sub-optimal outcomes as well as confusion in the communication between NERL and customers.
- **Over-bearing nature:** instead of the CMA’s intention of giving NERL ample opportunity to implement corrective actions, the more frequent assessments as proposed by the CAA seem to create greater risk of penalties.
- **Cap level:** instead of being set at a fixed amount of £36m, the cap should be scaled to the amount of investment within a price control period, to remain proportional. This is particularly relevant with any investment programme re-plan in light of Covid-19.
- **Threshold for scrutiny:** instead of being linked to change compared to the plan, the CAA has set it to any £10m amount, which would move consultation from a few key projects a year to many tens of projects. This is greater than the airlines

¹⁶ Interim SIP 2019, (REP024), para 10, p. 53

appetite for engagement (as indicated in our summer 2018 consultation) and would increase regulatory burden for NERL.

4.3.3. Request

24 We request that the CMA considers whether the CAA's proposals for the engagement incentive:

- delivers a net benefit to customers, in terms of regulatory burden versus likelihood of better outcomes; and
- meets their principles of user focus and proportionality.

5. Oceanic

- 25 While we welcome the CAA's acknowledgement that there will be need to be some flexibility on the timing of the mid-period review because of the fall in traffic volumes due to Covid-19, we will continue to use ADS-B on the current basis during this period because:
- the ADS-B safety benefits continue independent of traffic levels;
 - the ICAO agreement remains to implement ADS-B across the North Atlantic and us ceasing to do so unilaterally would have a network impact; and
 - the relevant contract break clause relates to regulatory approval, which is aligned with the regulatory reference periods and has a 6 month notice period, as described in our response to RFI13 or NERL009a, p. 8 and pp. 11-12.

6. Traffic risk-sharing

- 26 Some of the language in CAP 1910A could be interpreted as the CAA suggesting that the current traffic risk-sharing arrangement will be revisited¹⁷:

"In light of the impact Covid-19 and the limitations of the regulatory framework, we would also expect the 2021 review process to include consideration of what revenue correction, if any, should be applied to 2020 and 2021."

"whether there is a need for any reconciliation, taking account of evidence from and views of NERL and stakeholders"

6.2. Clarification

- 27 As part of its agreement with the CAA about the basis of an interim plan prior to re-opening the RP3 price control, NERL has acknowledged that any reconciliation of costs will need to take into account the unique circumstances of the operational environment during and following the COVID-19 pandemic. However, both CAA and NERL are clear that such an approach does not fundamentally change the regulatory principle that created the current traffic risk-sharing arrangements, which are vital for our ongoing liquidity, including the n+2 cost reimbursement mechanism. This is because:

- the principle was introduced by the CAA to ensure NERL's ongoing solvency following the reduced demand for air travel after the terrorist attacks of 9/11/18. Covid-19 is having a much larger impact on traffic volumes;
- NERL's initial actions in response to Covid-19 have to date only enabled us to offset the losses from the current revenue exposure limit of 4.4% of traffic in the UKATS business. Even though we have taken rapid and wide-ranging actions (as outlined in NERL031), we have been unable to take material further actions to date due to our significant fixed costs, reduction of which would require a fundamental redesign of our service and investment plan proposition which, in the absence of greater clarity thus far on the medium term impact on the UK air traffic environment, might lead to a breach of NERL's Licence. However, we are committed to further action as the outlook for the aviation market and its future becomes clearer; and
- There are other mechanisms available that may not undermine NERL's solvency¹⁹.

¹⁷ CAA 2020, *Reference to the CMA of NERL RP3 price control: CAA response to CMA's provisional findings: Appendix A – Responding to Covid-19, CAP 1910A*, p. 8

¹⁸ NERL 2019, *Overview of Air Traffic Management Industry and NATS (En Route) plc for the CMA*, p. 34

¹⁹ Oxera 2020, *Agenda: destination unknown airport-regulation in the wake of COVID-19*, p. 2 and Frontier Economics 2020, *Covid-19 challenging time ahead for aviation*, p. 7.

7. Conclusion

- 28 Nothing in the CAA's response to the CMA's PFs changes NERL's position of continuing to support the PFs relative to the CAA's RP3 Final Decision.
- 29 We have identified some important areas of concern and clarification in the CAA's response to the PFs, which we ask the CMA to take into account in reaching its FD.

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