NATS (En Route) Plc Regulatory Appeal

Summary of final report

23 July 2020

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. 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 RP3 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 RP3 Decision was £212 million, out of a total allowance of £2,956 million. NERL 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:

- 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);

- 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 was an unusual period as NERL was undertaking a significant upgrade of technology systems to replace legacy equipment and deliver a new technical architecture, with the associated training needs. NERL would also have a key role in the airspace modernisation strategy intended to improve the efficiency of airspace management in the UK. While the CAA owned the strategy and plan, delivery (including the design of any airspace changes) would be undertaken by other entities, such as airports, air navigation service providers or airspace users.

7. NERL and the CAA (together, the Parties) agreed that effective delivery of both the technology upgrade and airspace modernisation were in the public interest as they would deliver significant future benefits in terms of performance and resilience. We were also mindful of the primary duty of NERL being to ensure the safety of air traffic. In assessing the correct price controls in our provisional findings, we therefore carefully considered 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 was accounted for by the allowed regulatory return. This in part reflected differing views on how much risk NERL would be taking over the RP3 period.

Impact of COVID-19

9. During the course of our investigation, cases of COVID-19 began to appear and became a pandemic. There has been a substantial impact on air traffic volumes and NERL operations as a result, and there remains 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 reflected operating conditions prior to this event. We invited representations following our provisional findings on how we should take account of the impact of COVID-19 in our final determination and carried out a second consultation on how the CMA reference process should progress.

10. Following that consultation, we based our final report on our provisional findings, without making specific adjustments to take account of the impact of the COVID-19 pandemic, on the basis that these findings would be applied for a shorter period than planned in the CAA RP3 Decision, providing some certainty for the shorter term and enabling the CAA to commence a further review as the effect of the COVID-19 pandemic on air travel over the coming years may be better understood. We have therefore limited our work since provisional findings mainly to correcting inaccuracies identified in our provisional findings, and have furthered our assessment only in so far as it could have a longer-term impact, irrespective of COVID-19.

11. The CAA has confirmed that it will be reviewing the price control, based on a new NERL business plan and updated forecasts and financial assumptions, once the situation of the aviation sector reaches an adequate level of stability. As part of this review it will conduct a reconciliation exercise with reference to actual flight volumes and costs over the period since the start of 2020.

12. The Charge Control Conditions resulting from modifications set out in our final report should be applicable for three years, from 1 January 2020 to 31 December 2022 (the 2020-2022 Price Control), or until the implementation of a new price control following the CAA review in 2021.

13. The practical effect of this approach is that maximum charges for air traffic control services to airlines will in effect be set as if COVID-19 had not occurred, which should provide certainty to both NATS and its customers until such time as the impact on the industry can be better understood and a more comprehensive reworking of the regulatory settlement can be undertaken.

14. We have conducted a more thorough review of modifications to Condition 10, relating to capex incentive and governance, following our provisional findings, as these aspects of our determination are intended to have application beyond the 2020-2022 Price Control period.

15. This summary outlines the final determination made by the CMA on that basis.

Our approach to the reference

16. In addressing the reference questions, we need to consider whether Condition 10 and the Charge Control Conditions in NERL's licence as they currently stand 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:

- the primary duty to maintain a high level of safety, and
- 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.

17. 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.

18. 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 RP3 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

19. In considering the first reference question we noted that, as a result of NERL 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 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.

20. 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 operate against the public interest and could lead to adverse effects, including higher prices than necessary because NERL would be not be constrained when setting prices in earning profits relative to its cost of capital, poorer customer service and inefficiencies in implementing the Airspace Modernisation Strategy.

21. 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 benefits for this operation

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

22. 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 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 consider the adverse effects would be remedied or prevented.

23. 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 are balanced and provided consistent incentives while not making it unduly difficult for NERL to finance its activities, taking into account the CAA review and reconciliation which will be taking place in 2021.

Service Delivery Targets

24. 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.

25. We concluded that these targets, reporting basis and associated incentives should be applied in line with those proposed in the CAA RP3 Decision. We did not see sufficient evidence to persuade us that it was unrealistic for NERL to maintain good performance, even during the delivery of the airspace modernisation programme.

26. However, the service quality and environmental targets and associated incentives included in the 2020-2022 price control should be reconsidered and potentially amended by the CAA once the impact of COVID-19 is better understood. The CAA should consider in its review of the price control the extent to which any rewards earned during the CMA determined price control period may be applied, taking into account the actual level of flight volumes and appropriateness of delay targets in that period.

Traffic Forecasts

27. 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.

28. 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. We conclude that it is appropriate for the CAA to use the STATFOR forecasts, and that the February 2019 STATFOR forecasts should be retained as the basis of calculations of applicable airline user charging for the period of the CMA determined price control, given the current uncertainty due to the impact of COVID-19 on air traffic.

Opex

29. 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 RP3 Decision. NERL's revised business plan (RBP) included £2156 million of opex, to which the CAA RP3 Decision applied a £43 million reduction.

30. 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 RP3 Decision. For example:

- The CAA described the opex efficiency challenge in its Decision as modest, and the opex allowance as relatively generous.
- 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.

31. The CAA RP3 Decision provided an opex allowance that was 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.

32. Given the extent of these proposed increases, we considered it important that the CAA, as the economic regulator, sought to carefully scrutinise NERL's plan and that it 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.

33. 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 considered that the CAA had carefully reviewed these priorities, alongside its duties to airspace users, in developing its RP3 Decision. We noted, in particular, that its decision to apply a 2% reduction in opex relative to NERL's RBP sat 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.

34. We considered NERL's concerns with respect to the potential operational and safety risks that might be associated with the CAA RP3 Decision to be misplaced, and to be out of line with the regulatory framework that applies.

35. We therefore conclude that the opex allowance should be applied in line with that proposed in the CAA RP3 Decision when calculating NERL's determined costs for the period of the 2020-2022 Price Control.

Capex

36. 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.

Capex allowance

37. 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 considered it likely to be important that there would be further engagement on and scrutiny of these projects, and their associated costs, during the period of the price control as NERL's plans evolve, and that the CAA RP3 Decision on the level of capex allowance was 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 were amended in the ways set out below.

38. We conclude that the capex allowance should be set in line with the CAA RP3 Decision when calculating NERL’s determined costs for the 2020-2022 Price Control .

Capex governance

39. 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. We noted, in particular, that NERL pointed to its support for strengthening the role of the Independent Reviewer, but raised concerns over a lack of clarity with respect to the reviewer’s remit and accountability in a context where its assessments could have material impacts. We concluded that the capex governance proposals included in the CAA RP3 Decision, that strengthen the Independent Reviewer role and require quarterly service and investment plan (SIP) updates, should be applied.

Capex incentives

40. The CAA RP3 Decision introduced three separate capex incentives: a) an efficiency incentive; b) a capex delivery incentive, and c) an information incentive.

41. As regards the efficiency incentive, we considered that the CAA RP3 Decision implied that the basis upon which the CAA would consider Regulatory Asset Base (RAB) disallowances following ex-post efficiency reviews had changed materially. However, the CAA had not codified the basis upon which it might apply a RAB disallowance to a sufficient degree, or in a sufficiently constrained manner. We considered 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.

42. We welcome the CAA’s development of a draft Regulatory Policy Statement (RPS) describing the Demonstrably Inefficient or Wasteful Expenditure (DIWE) test that it intends to apply, and NERL’s broad support for that. We consider the CAA’s draft RPS to specify sufficiently the basis upon which the CAA would expect to apply a disallowance of capex, following an ex-post efficiency review. We do not consider the level of detail provided in the RPS to

be suitable for inclusion in a licence modification. However, we consider that the DIWE test, and the RPS concerning how that test is to be applied, should be referred to in the licence. Overall, we conclude that this would sufficiently specify and constrain the basis upon which the CAA would be expected to apply a disallowance of capex, following an ex-post efficiency review, and thus address the concerns identified above.

43. In our provisional findings, we concluded that the capex delivery incentive in the form proposed by the CAA would result in NERL facing undesirable additional risks associated with uncertainty over the regulatory treatment of capex that may be captured by it. We considered that the CAA provided little clarity over how its proposed capex delivery incentive might be applied, and little guidance that might assist NERL with managing the risk that it might 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.

44. We considered 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 provided our initial views on an appropriate starting point for the development of such specification and invited submissions on how these arrangements might be developed.

45. We welcome the CAA's development (since our provisional findings) of more detailed guidance on how this capex engagement incentive could be applied, and consider, subject to certain adjustments, that guidance provides appropriate specification concerning how NERL's performance would be assessed, and the basis upon which the level of any penalty to be applied would be determined. We also welcome NERL's engagement on this issue.

46. Last, we conclude that the CAA's proposed information incentive should not be introduced. We consider that any capex that may result in NERL exceeding the level provided for by its allowance in the price control should be assessed within the capex delivery incentive (amended in the manner described above), and not subject to separate incentive arrangements.

Non-regulated income

47. 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 anticipated 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 had agreed that the total non-regulated revenue for RP3 should be £446 million.

48. 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.

49. We conclude that there should be no additional reduction in the determined cost allowance 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

50. 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 disagreed on the interpretation of the requirements to apply this.

51. 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 RP3 Decision). The total allowance for pensions in the RP3 Decision was £392 million.

52. We conclude that a pension cost adjustment should be applied to the assumption of NERL’s costs, based on the CAA’s approach applied to the 2020-2022 period offset by approximately £3 million to reflect a smaller ongoing cost adjustment than that made by the CAA. 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 CAA’s proposed approach of preparing a Regulatory Policy Statement (RPS)

represents an opportunity to make this clarification and the CAA has confirmed its intention to consult on this.

Oceanic

53. 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 could then influence the regulatory allowance for this new Oceanic service in the final two years of the RP3 price control.

54. In its RP3 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 RP3 Decision included allowances for £211 million associated with Oceanic services, which was £12 million less than in NERL’s RBP.

55. 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.

56. We accepted that implementation of ADS-B is justified on the ground that it enables the UK to meet the International Civil Aviation Organisation (ICAO) North Atlantic Tracks target level of safety, and that the UK as a signatory to the ICAO must seek to meet global safety standards which remain in place notwithstanding COVID-19. We agreed with most of the CAA’s approach to the Oceanic services, including its decision to fund the costs of ADS-B, subject to an independent review. We consider that the CAA should be clearer and more transparent about the methodology, conduct and consequences of the proposed independent review. We encourage the CAA to consider its approach and consult on this by the end of 2020.

57. We have however made 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

58. We received detailed representations from the Parties and third parties containing a range of views on the appropriate approach to calculate the cost of capital for NERL, including as initial submissions, following our provisional findings, and in response to consultation on our approach to COVID-19.

59. We have performed our own determination of the cost of capital. We started with the framework used by the CAA and NERL – the Capital Asset Pricing Model (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.

60. As explained earlier, given the ongoing uncertainties affecting the aviation sector, we have not refined our assessment in detail following our provisional findings, or made specific adjustments to take account of the impact of the COVID-19 pandemic, as this would not have allowed us to reach figures that accurately reflected the effects of the pandemic on determined costs. We also note that the majority of respondents to our COVID-19 consultation who expressed a view in this area also considered that now is not the right time to review the cost of capital.

61. Our final report therefore sets out the approach used to determine our provisional conclusions on the appropriate cost of capital for NERL. We updated only the 'vanilla' Weighted Average Cost of Capital (WACC) estimate from our provisional findings to reflect additional clarification from CAA and NERL on the measure of embedded debt to be used within the cost of debt analysis. We also calculated a pre-tax WACC to be used in setting charges, based on modelling used by CAA and NERL. We have not updated the market data or made changes to the methodology that we applied in calculating the WACC based on the responses to our provisional findings or to our COVID-19 consultation. As a result, the approach in our final report does not reflect any assessment of the merits of the points raised in these responses.

62. On this basis, we conclude that the modification proposed in the CAA's decision set the cost of capital below a level which properly balanced its objectives in determining NERL's assumed return. Our conclusions on

NERL’s cost of capital are to use a vanilla WACC of 3.05% and a pre-tax WACC of 3.48% for the CMA determined price control. Based on an RPI inflation forecast of 2.9%, this would be comparable to a nominal pre-tax WACC of approximately 6.5%.

Overall assessment of the price control

63. In our provisional findings, 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 were 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 had provisionally proposed was balanced, that there were no conflicting incentives, and that the modifications set out in our report would, at the date they were delivered, remedy the effects adverse to the public interest.

64. At the time of our provisional findings, we estimated the financial impact of our conclusions on NERL’s finances to check that it would be financeable. At that time, we considered that NERL would not find it unduly difficult to finance activities authorised by its licence on the basis of our provisional findings.

65. Since then, the impact of COVID-19 on air traffic has had a significant impact on the operations and finances of NERL. The CAA told us that in these extraordinary circumstances where there is insufficient air traffic to reasonably support NERL’s business activities, NERL’s price control did not provide levers that could deal with issues such as liquidity, and that it considered it was for NERL’s management, its providers of finance and Government to determine how best to address short-term issues associated with liquidity and NERL’s financial position.

66. Given that the immediate impact of the pandemic will be addressed through other means, we are satisfied that the CMA determined price control, combined with the CAA review and reconciliation in 2021, will not in themselves unduly affect NERL’s ability to finance activities authorised by its licence. We recognise that COVID-19 has had an adverse effect on NERL’s finances, and we expect that this will be considered by CAA in its decision on a future price control.

Our final determination

67. Our final determination, summarised above, will form the basis of the price control for an interim period from 1 January 2020 until 31 December 2022. The CAA will carry out a review of the price control within that time, including a reconciliation with actual data from the period affected by the COVID-19

pandemic. The CAA has confirmed that it will be reviewing NERL’s price control in 2021 when the timing and shape of the recovery in air traffic should be starting to become clearer.