British Airways plc
Waterside
PO Box 365
Harmondsworth UB7 0GA

Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD

cc: economicregulation@caa.co.uk

15th April 2021

British Airways Response to CAP2119
Update on approach to next price control: NATS (En-route) plc

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of NATS (En-route) plc ("NERL"); we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

Executive Summary

We welcome the CAA's latest publication on the regulation of NERL:

a) We support the implementation of a new price control for five years from January 2023, noting that this **requires key target dates to be established rapidly to enable the process to take place without delay**

b) We **support a reconciliation of 2020 and 2021 based upon efficient costs**, but caution that a 2022 **reconciliation based solely upon forecasts might result in unintended consequences** for economic incentives over efficiency

c) We **agree with the CAA approach to follow European guidance in recovering revenue** under NERL's Traffic Risk Sharing ("TRS") scheme over an extended period from 2023, relying upon and reconciling the Competition and Markets Authority ("CMA")'s settlement for 2022 until the periodic review has concluded

d) We will engage with the CAA's consultation on affordability, though consider that its **final definition can only be truly established in the context of a complete price control package**, and the balance of risk and incentives within such proposals

e) We support the CAA's approach to developing a regulatory framework for the next price control period, which **seeks to maintain existing arrangements where possible and appropriate**

f) We **welcome the finalisation of a Regulatory Policy Statement ("RPS") on pensions**, which ensures appropriate clarity for NERL and the Trustee of regulatory treatment in advance of the triennial valuation of the defined benefit scheme

1. Reconciliation of TRS arrangements

1.1. The price control established by the CMA for RP3 was set in July 2020 with a requirement that – since volumes and costs were by then too difficult to establish during the onset of Covid-19, that a **reconciliation for 2020 and 2021 would be required when more information was available**, and prior to the next periodic review

1.2. The CAA propose to reconcile costs and revenues for 2020 and 2021 based on efficient costs; **we support this position, since it will ensure economic incentives remain effective**. To do otherwise would result in situations that could either over-reward NERL where costs could have been lower, or even under-reward NERL where management effort has exceeded what could have been expected on an efficient basis

1.3. Following this approach will therefore **ensure consistent economic incentives over time, and support the continuing integrity of TRS arrangements**; we further agree with the CAA that this assessment **should be performed in a manner that is both reasonable and achievable**

1.4. Any form of focussed review must **seek to understand the appropriate efficient level of costs**, with a focus on ensuring that economic incentives on NERL remain consistent, such that incentive regulation is not inadvertently undermined

1.5. As part of such a review, the CAA should consider matters including furlough usage, severance packages, long-term training and resource planning requirements, and the appropriate pace of investments in technology

1.6. We also note the CAA propose to allow recovery of revenue over a longer period than the current two-year time lag when recovery is usually incorporated into charges; **we support longer-term recovery of revenue**, and believe this approach does not compromise the current regulatory framework, but supports it

1.7. Furthermore, **we agree with the CAA that revisiting the TRS arrangement does <u>not</u> create additional regulatory risk**; since the thresholds and provisions of the TRS are fully established in NERL's existing licence, **the CAA's actions in relation to this are fully consistent with the existing licence and incentives**

1.8. As noted by the CAA, the European Commission ("EC") proposes recovery of charges for Air Navigation Service Providers ("ANSPs") over a five to seven year period from 2023; **collection of charges is integrated within Eurocontrol based upon common en-route calculation rules**, therefore following this approach ensures the recovery of NERL revenues follows a common approach to ANSPs across Europe

1.9. This does not preclude NATS ultimately recovering its revenue over time, but ensures the TRS arrangements remain effective to the same extent as originally envisaged; therefore, in order **to ensure the balance of risks and regulatory commitment are maintained, recovery of revenue due under the TRS is appropriate**

1.10. The CAA should within this consider its approach to government furlough support when considering both the TRS and efficient costs; we also recognise that when recovering revenue due under the TRS over time, this should be in a manner consistent with supporting NERL's financeability on an ex-ante basis

1.11. We note that **the CAA's approach may require equity support**; from the perspective of our position as a user of regulated services, we support the CAA's aim to primarily use conventional regulatory levers and mechanisms to manage affordability, resorting to shareholder support if ultimately required

1.12. Following previous consultations, we also support the CAA's proposal to carry out further work on defining affordability; we recognise that without amendment to the recovery mechanism, the prospective adjustment to 2022 charges as a result of Covid-19 could be **unaffordable if charges were to escalate in a manner that would be unlikely to have occurred in a competitive market**

1.13. Affordability should be considered in the context of efficient pricing that maximises total economic surplus, both that of the consumer and the regulated firm's profit; in the context of regulatory economics, it is usually the **output of appropriate building block inputs, incentives and risk allocation that result in efficient pricing**

1.14. Whilst TRS recoveries create an additional layer of complexity, "affordable" charges are unlikely to be meaningfully defined in isolation without considering the entire regulatory package alongside the impact upon future charges; as a result, **affordability may be best assessed as a core part of the next periodic review** in order to consider all elements of the charge alongside each other

1.15. In that respect, an **appropriate balance is required to ensure that affordability is considered in terms of the overall regulatory package**, including the balance of risk and NERL's technology investment; if only short-term affordability is considered in isolation, undesirable consequences could result in the longer-term

2. The new price control

2.1. The CAA propose to start the next price control for five years in January 2023, allowing greater time for a periodic review to be completed, and avoiding the inherent uncertainty of aiming to start the next price control in January 2022, **relying on the CMA's price control arrangement for 2022**

2.2. **We support this approach to ensuring that a complete periodic review is delivered** over the course of the next 20 months, and urge the CAA to set out clear timetables for delivery that allow NERL, airlines and other interested parties to plan their resources to engage in this process with appropriate rigour

2.3. Further to our previous comments, **we agree that this will require modification of the TRS arrangements for 2022** to defer the recovery of revenue from 2020 to the new main price control period, resulting in unit charges for 2022 are set at the existing levels determined by the CMA and remain broadly "affordable" as a result

2.4. Nevertheless, we are **concerned how a reconciliation might operate based only upon forecast information for 2022**; the future is not clear at present, with an uncertain recovery and international restrictions potentially creating material deviations between forecast and out-turn figures

2.5. This could create a **risk that the TRS might be reconciled to a forecast that itself materially deviated from out-turn**, resulting in a risk of greater gains or losses for NERL than would be appropriate based upon economic incentives for efficiency

2.6. It **may therefore be more appropriate to perform both an interim reconciliation**, based upon best available forecasts for 2022 at the time, **and a subsequent full reconciliation** to 2022 efficient out-turn at some point in 2023

2.7. Whilst this may appear to duplicate effort, **it would be difficult otherwise to ensure that incentives remain consistent over time**; the new price control would also therefore require an adjustment mechanism to account for a final reconciliation

2.8. Nevertheless, **we are supportive of a licence modification to replace the current TRS mechanism**, which would otherwise allow NERL to recover 2020 revenue shortfalls in 2022 and cause a large increase in charges, as not doing so could compromise any recovery in 2022, and in extremis result in carriers routing to avoid airspace, reducing NERL's ability to recover those revenues

3. Future regulatory framework

3.1. We support the CAA's approach to developing a future regulatory framework at the forthcoming periodic review; particularly in **ensuring NERL has appropriate efficiency incentives that mimic competition and ensure charges are appropriate**

3.2. This is consistent with the CAA's duties under the Transport Act 2000 ("TA00"), whose explanatory notes specify that "furthering the interests of airlines, their passengers and freight customers, and airports, [includes] furthering those interests through promoting competition, where appropriate"[1]

3.3. We are **supportive of ensuring that the next price control is financeable**, and ensures there is capacity to invest in the longer-term, whilst avoiding any undue

[1] Transport Act 2000, Section 1, General Duties: explanatory notes.

increases in NERL's cost of capital; we stress that regulation should seek to set ex-ante incentives to support these over the course of the price control

3.4. This is consistent with the CAA's confirmation of approach to TRS reconciliation that was critical in supporting an efficient refinancing of NERL's bank facilities in 2021, which would have allowed banks to gain confidence that existing risk allocation specified in the TRS was to remain in place in future

3.5. **It is reasonable that the CAA seeks to maintain existing arrangements where possible and appropriate**, only making changes to deal with the increased level of uncertainty and the greater challenges associated with financeability and affordability

4. Regulatory Policy Statement: Pensions

4.1. We **support the CAA's finalisation of a Regulatory Policy Statement ("RPS") on pensions**, which ensures appropriate clarity for NERL and the Trustee of regulatory treatment in advance of the triennial valuation of the defined benefit scheme

4.2. We agree with the CAA's expectation that NERL, in working with the Trustee, should **consider and take all measures to ensure pension costs are efficient and reasonable**, to the benefit of present and future consumers, supporting economic incentives

4.3. Furthermore, we note NERL's estimated benefits to consumers of the RPS stand at £320m, a material sum; given the materiality of these pass-through costs incorporated in NERL's user charges, we **support NERL in continuing to work with the Trustee to further reduce pension costs**, and consider all options in doing so

5. Process and key deliverables

5.1. We note that the Air Traffic Management and Unmanned Aircraft ("ATM&UA") bill, currently before Parliament, which – as noted by the CAA – will likely change the licence modification process and appeal rights compared to TA00

5.2. Given likely ATM&UA requirements appear to require three months at the end of the process to enable licence modifications, this **suggests that the remaining 20 months to January 2023 are already on a compressed timeline**

5.3. British Airways will endeavour to be flexible and contribute to a process that allows the CAA to implement a new price control within the next 20 months, and we agree with the CAA that **this requires key target dates to be established rapidly to enable the process to take place without delay**, and allow a January 2023 implementation

5.4. We will therefore **support the CAA in developing this timetable as a priority**, and look forward to engaging with NERL in developing its business plan for RP4

Yours sincerely,

Alexander Dawe
Head of Economic Regulation
Networks & Alliances
British Airways Plc