NERL response to the CAA's consultation on exceptional measures (CAP 2245)

28 October 2021

NATS

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Summary

2022 licence modifications

NERL agrees with the licence modifications that the CAA is proposing for 2022, with the exception of its proposal for 3Di.

For our 3Di score, we believe that the CAA's modification to our Licence to remove non-revenue flights should reflect actual data instead of a proxy that is wrong.

For the implementation of exceptional measures in response to the 2020 traffic fall caused by Covid-19, we support the CAA's proposal to prevent an unprecedented increase in 2022 charges. Consistent with the treatment of 2020 revenues, NERL agrees that the CAA should also suspend the recovery of 2021 and 2022 Traffic Risk Sharing (TRS) revenues through the automatic two-year lag included in our Licence. Instead, we support the recovery of these revenues being determined through the NR23 review, and recovered in large part over the NR23 period.

NERL has always recognised that it would be inappropriate for it to receive a bonus in relation to service quality performance in 2020 due to the exceptional nature of the Covid-19 pandemic and its dramatic impact on traffic levels.

Our agreement to the proposed 2022 licence modifications is a positive contribution by NERL for the benefit of our customers. In return for deferring our rights to revenue and volunteering not to claim service quality bonuses for 2020, we believe that a balanced response from the CAA would be to provide certainty on an economically rational treatment of the revenue shortfall, and clarity on the operation of service incentive mechanisms in the event of future exceptional circumstances.

NR23 policy principles update

We support the CAA's update on its policy principles that relate to the 2020-2022 period, apart from its approach to financing costs.

We welcome the CAA's clarification that it intends for us to recover the full TRS shortfall in revenues, subject to their assessment that the costs we incurred during this period were not inefficient given the information available to NERL at the time. However, it will be important that this assessment is conducted with the same principles that apply to the CAA's *ex post* efficiency assessments in relation to capital expenditure. In particular, the starting presumption ought to be that expenditure should be allowed, with the onus of proof being on the CAA throughout to demonstrate that the expenditure was inefficient rather than NERL having to prove it was efficient.

We are proposing options to customers about the timing of the revenue shortfalls arising from the pandemic shock, as part of our NR23 business plan discussions with them this autumn. Regardless of timing, we do not agree that there should be different financing costs for this money. Our concerns relate to maintaining fundamental aspects of the regulatory framework on which our long term financing rests, as well as practical considerations. In summary, all financing raised by NERL should be treated equally, with no imputed hypothecation of a particular funding source against specific purpose or application. We also note the increase in gearing, necessary to manage the revenue deferral, will have increased the cost of equity, and that the overall risks to NERL in the NR23 period, and hence the allowed cost of capital, should be assessed in the round as part of the price review. Our ability to refinance and increase gearing was only possible because of dividend restraint, which represents a material shareholder contribution. In return for contributing to funding the revenue shortfall over five years, NERL's shareholders have a legitimate expectation of continuing to earn the cost of equity on their investment over this period and of receiving normal dividend payments over the period, consistent with this cost of equity.

1. Traffic risk-sharing mechanism

1 This section responds to Chapter 1 in the CAA's consultation document regarding the traffic risk sharing mechanism (TRS). It also covers the implementation of relevant licence modifications for 2022 as drafted in Appendix A ("modified conditions").

2 NERL maintains its previous positions in relation to 2022 charges, as follows:

- 2023 reset: NERL has consistently sought a 2023 reset, to mitigate the likely impact of the increase in its charges on airlines from re-baselining traffic while traffic levels continue to remain low and uncertain, and also for more cost-effective planning in NERL[1].
- 2020 revenues: similar to above, NERL recognises the negative impact that an exceptional increase in its charges relating to recovering its 2020 TRS revenues would have on the aviation sector in 2022, which we are able to support during the NR23 period due to a significant debt restructuring completed in June 2021; and
- 2020 service performance bonuses: NERL continues to recognise that it would be inappropriate for it to claim a service quality bonus for 2020 performance that is largely driven by traffic falls rather than our own efforts, which we volunteered not to do[2].

1.1. Cost reconciliation approach

3 We support the CAA's policy principle of reconciling costs and revenues for 2020, 2021 and 2022 on the basis of those costs not being inefficient, judged on information available to NERL at the time (a process called "retrospective reconciliation").

4 For the CAA's methodology, we support the 1) CAA adjusting costs (where need be) so that NERL does not receive money twice; and 2) to reflect evidence that NERL incurred costs inefficiently during this period. On the first point, we consider that the CAA should not have to adjust our operating costs for furlough as we have already netted the grant income received against our costs, and so effectively will pass back these savings to customers.

5 On the second point, with regard to assessing evidence of NERL's inefficiency, the CMA highlighted the importance of the CAA referencing actual flight volumes and costs over the period since the start of 2020[3]. A similar approach has been agreed by European Commission in relation to other

[1] NERL 2021, NERL *response to CAP 1994*, https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airspace/Air_Traffic_Control/NERL%20(CAP1994).pdf, (accessed 14 October 2021), pp. 5-6

[2] NERL 2021,, *NERL's response to CAP2119,* https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airspace/Air_Traffic_Control/NERL%20(CAP2119).pdf (accessed 14 October 2019), p.3 and p. 5.

[3] CMA 2020, NERL/CAA regulatory appeal, p. 3.

ANSPs "*… the actual costs incurred by ANSPs and Member States will be taken into account, except where those costs compromise unjustified or ineligible cost items*"[4].

6 Practically, we expect this to mean that the CAA will adopt the principles and approach which already guide its *ex post* efficiency assessment of NERL's capital expenditure, as set out in its Regulatory Policy Statement[5]. This allows the CAA to draw on an established codification for how it might disallow NERL costs, including operating within clearly defined self-imposed constraints as outlined by the CMA. The CMA emphasised the importance of having these safeguards in place for what is essentially a new policy approach by the CAA in relation to NERL, which we believe is highly relevant here[6]. The most important constraint on the CAA's judgement will be taking account only of information available to NERL at the time and not drawing on the benefit of hindsight. The CAA should resist the natural human tendency to base its view on all information available to it at the time of assessment - which would result not in a true review but a retrospective retaking of the original decision. In addition, it will be important that the CAA takes account of:

- NERL's own operational efficiency (including benefits to users in the longer term of decisions taken in responding to the near term challenges raised by the pandemic); and
- NERL efficiently and effectively complying with its statutory and regulatory obligations.

7 These principles mean we question whether benchmarking should be used as a methodology at all for assessing NERL's efficiency in its retrospective reconciliation. The CAA's definition of Demonstrably Inefficient or Wasteful Expenditure (DIWE) in its December 2020 Regulatory Policy Statement, which was supported by the CMA in the RP3 reference, states: *"For the avoidance of doubt, no expenditure is Demonstrably Inefficient or Wasteful Expenditure simply by virtue of a statistical or quantitative analysis that compares very aggregated measures of the NERL's costs with the costs of other companies.[7]"* Benchmarking shifts the onus of proof away from the CAA and towards NERL similar to *ex ante* assessment, when the CMA and CAA have stated that the onus should remain throughout with the CAA for *ex post* assessment.

8 Practically, benchmarking would mean assessing NERL's actions in light of the actions of others which may or may not have turned out better given the significant unknowns which subsequently materialised after decisions had been made e.g. UK government policy, other government policies, new variants, second and third waves, multiple changing traffic outlooks with no consistency across sources. Benchmarking is an inappropriate and ineffective technique for comparison given the level of uncertainty which existed at the point of decision making; it unavoidably fails the test of assessment with the benefit of hindsight as a result. It is also worth noting that the Performance Review Body's Monitoring Report for 2020, which offers the opportunity to compare ANSPs' immediate response to Covid-19 across Europe, only became available in October 2021[8].

9 There are parallels between the forthcoming CAA *ex post* assessment of our expenditure in 2020 and 2021 and the *ex post* assessment it has recently undertaken of Heathrow's 'early expansion costs' related to its third runway development plans. The CAA describes the latter, in its Initial

[4] European Commission, Minutes of the Appeal Committee of 12 October for recital 11 relating to Commission Implementing Regulation (EU) 2020/1627 of 3 November 2020 on exceptional measures for the third reference period (2020-2024) of the single European sky performance and charging scheme due to the COVID-19 pandemic
[5] CAA 2020, *Economic regulation of NATS (En Route) plc: Decision on licence modifications and guidance - CAP2011*, pp. 73-77.
[6] CMA 2020, *NERL/CAA regulatory appeal*, pp. 112-113.
[7] CAA 2020, *Economic regulation of NATS (En Route) plc: Decision on licence modifications and guidance - CAP2011*, p. 74.
[8] Performance Review Body 2021, *Monitoring Report 2020*.

Proposals for the Heathrow H7 price review: "*a significant component of our approach to early costs involves assessing whether there is evidence of inefficiency and so there is a degree of consistency across these approaches* [early expansion costs assessment and DIWE framework for *ex post* capex assessment]."[9] We consider that the CAA's forthcoming review of our 2020-21 expenditure should similarly be consistent with the principles in place for the DIWE framework for *ex post* capex scrutiny.

1.2. TRS debtor treatment

10 We are proposing options to customers about the timing of the Covid-19 revenue shortfalls as part of our NR23 business plan discussions with them this autumn. The presumption that NERL will be able to recover all of the revenue shortfall from 2020-2022 period within the NR23 period is noted, which is consistent with the base assumption in our NR23 business plan. We welcome the clarity that although substantively recovered in NR23, any remaining balance would be fully recovered in NR28. We are exploring what NR28 recovery could mean practically with our customers in terms of options to our base assumption.

11 We are pleased that the CAA supports our approach of continuing to include Traffic Risk Sharing revenues in our Regulated Asset Base (RAB) through working capital. We agree with the CAA that the certainty offered by the RAB is consistent with having the TRS mechanism in our Licence currently. Our Licence has set strong expectations about regulatory treatment of the TRS, including with investors, and this is critical to our financeability.

1.3. Financing costs treatment

12 We agree with the CAA that it is appropriate for it to set an allowance for NERL to finance the costs associated with the delayed TRS recovery. In June 2021, to ensure NERL would be well placed for a range of recovery outcomes from Covid-19, we completed a full refinancing and restructure of our debt. We secured £1.6bn of funding by issuing £750m of unsecured bonds and agreeing £850m of new unsecured bank facilities. This facilitated the redemption of existing bonds as well as the repayment and cancellation of existing bank borrowings, including a £380m facility agreed in August 2020 which provided additional liquidity in response to Covid-19[10].

13 We believe the following factors to be relevant to the CAA's assessment of what cost of financing is appropriate for the 2020-2022 shortfall in TRS revenues:

- Whole of business level funding. The debt and equity funding of the TRS revenue shortfall has come from funding which assesses NERL as a whole. The funding of the TRS revenue shortfall cannot be differentiated from the overall funding of the business. As such, there is no concept of differing costs of capital within NERL's funding. It would therefore not be appropriate artificially to create a cost of capital for just the TRS revenue funding.

- Funding from a combination of debt and equity. The debt funding came initially from pre-existing bank facilities. The equity funding has arisen from dividend restraint over a number years, which has been reinforced by no dividend payments since November 2019. NERL's cost of debt and capacity to raise the level of debt have been underpinned by this dividend restraint

[9] CAA 2021, *Economic regulation of Heathrow Airport Limited: H7 Initial Proposals, Appendices CAP2265E*, paragraph F12
[10] NERL 2021, https://www.nats.aero/news/annual-report-accounts-2021/ (accessed 13 October 2021

and the initial low gearing, just prior to the start of the pandemic. Shareholders have been committed to supporting customers through continued restraint. They have choices with regards to where to invest scarce capital, and therefore should be compensated at the regulatory-determined cost of equity to avoid unintended consequences on both financeability and the long term cost of capital.

- Not initiated by NERL. Unlike the regulatory precedent for "split returns" that arises from the decision by Firmus Energy, in Northern Ireland, to set tariffs below the permitted cap in order to promote the take-up of gas, NERL's revenue shortfall has arisen from an exogenous factor – namely initial traffic shortfalls and ongoing support to assist with maintaining stability of prices for airlines. As these shortfalls did not arise from a corporate business strategy decision to lower prices but rather from the operation of the regulatory mechanism for traffic risk sharing in the face of a massive demand shock, the regulatory precedent arising from the CMA and Northern Ireland Utility Regulator decisions in relation to Firmus Energy are not relevant to our situation.

- Single NERL business. NERL has one market into which it sells, one technology and one regulatory model. These factors align with one WACC. Counter examples from other businesses, such as BT Openreach, differ on all three factors. For example, Ofcom sets different costs of capital for Openreach for different parts of its business (Leased lines, Wholesale Local Access) which operate in different markets using different technologies and each facing different degrees of competition.

- Traffic risk sharing is already reflected in the WACC. The CAA references its view that the traffic risk sharing adjustments shield NERL from risk. We agree with this view and indeed both CAA and the CMA considered this aspect of the regulatory mechanism when setting NERL's WACC for RP3. Therefore, the effect of such shielding is already reflected in the methodology that is employed to determine NERL's WACC. We note that a traffic risk sharing mechanism for NERL has been in place for several price review periods, with benefits flowing through to customers over that time by virtue of the cost of capital being lower than it otherwise would be.

We also observe that the CAA considered the case for a split cost of capital extensively nearly a decade ago, in the context of the H6 price control review for Heathrow. It concluded clearly then that it would not be appropriate to adopt this approach for HAL for Q6[11]. It has not returned to this concept in the current H7 review.

1.4. Licence modifications

14 We do not agree with the traffic multiplier in the formulae for the temporary base charge adjustments related to the difference between the 2020 Oceanic charges between the CAA's Final Decision and CMA's Final Determination for RP3. This appears to be a drafting error as it should just be the simple difference. Therefore, "Actual Atlantic Flights$_{2020}$" and "Actual Tango Flights$_{2020}$" should be deleted from ATCA$_{2022}$ and TTCA$_{2022}$.

[11] CAA, Economic Regulation at Heathrow Airport from April 2014: initial proposals, CAP107, April 2013

2. Service quality incentives

15 This section responds to Chapter 2 of the CAA's consultation document about service quality incentives.

2.1. Approach

16 In response to the CAA's policy update for NR23 in March 2021[12], in which the CAA highlighted that it would be considering what might be the appropriate treatment of service quality incentives for 2020, we volunteered not to claim them for 2020 in 2022. This approach was confirmed in the 2020 Regulatory Report and Accounts we issued in July 2021. We recognised that it would be inappropriate to do claim financial incentives when the service scores on which they were based were mainly affected by traffic decline rather than our own efforts: "*NERL agreed with customers and the CAA it will not seek to recover a service bonus for 2020 as performance has been largely driven by low traffic volumes associated with the impact of Covid*"[13].

17 However, we have requested that the CAA adopts a consistent approach during this highly uncertain period as we recover from Covid-19. We therefore support the CAA's proposed approach that the incentive system be suspended completely ahead of NR23 because of the high degree of unpredictability in demand currently faced by the aviation sector. Notwithstanding this regulatory adjustment, we will continue to deliver good outcomes for customers in terms of delay and 3Di performance.

2.2. Licence modification

18 We support the CAA's approach for implementing this licence change, which is to set the relevant amount to zero in 2022 charges.

[12] CAA 2021, *Economic regulation of NATS (En Route) plc: Update on approach to the next price control review - CAP2119,* Economic regulation of NATS (En Route) plc: Update on approach to the next price control review (caa.co.uk) (accessed 15 October 2021), p. 30
[13] NERL 2021, *NERL Regulatory Accounts 2020*, p. 17

3. Other licence modifications

19 This section responds to Chapter 3 in the CAA's consultation document about other licence modifications, including their implementation as drafted in Appendix B (regarding "3Di annual review protocol").

3.1. CMA uplift

20 We support the CAA's approach of correcting for the difference in 2020 prices between the CAA's Final Decision and the CMA's Final Determination in 2022 charges.

21 The alternative would be to incorporate this adjustment in the retrospective reconciliation for NR23. However, making the adjustment in 2022 means the CMA's Determination is implemented as soon as is practically possible. Plus, it simplifies the retrospective reconciliation exercise by not adding another task to it, which facilitates transparency.

3.2. 3Di annual review protocol

22 As noted above, we support the CAA's simplifying approach to implementing revisions for charges for 2022, given that changes will be made again next year to implement their NR23 decisions. However, we do not support this approach where it is not a representation of reality, which is the case for its proposed methodology for excluding non-revenue flights from NERL's 3Di score.

23 In its RP3 decision, the CAA agreed to exclude non-revenue flights from NERL's 3Di score in recognition that these flights have a disproportionately large impact on the 3Di score and do not typically seek to maximise flight efficiency. Based on estimates by NERL, this was expected to remove around 0.6 3Di points from the score. However, rather than excluding the flights from the score, the latest Licence modifications adopt the use of a proxy adjustment through the removal of 0.6 points. However, we know this relationship is not a static one. For example, the downwards adjustment is almost 2 in the low traffic environment since Covid-19, where non-revenue flights are a larger proportion of total flights than normal. Therefore, we think this Licence change should reflect the underlying proposition, through the removal of all identified non-revenue flights, instead of using a proxy. We also think that this is consistent with the correct drafting approach to be taken to a legal instrument such as a statutory licence.