

# Guidance for NERL in preparing its business plan for Reference Period 3: consultation document

CAP 1593



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## About this document

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This consultation document seeks views from all interested parties on the CAA's approach to business plan guidance to NERL for the period from 2020 to 2024. Following consideration of feedback on this document and engagement with stakeholders, we intend to publish final business plan guidance for NERL in January 2018.

The NERL business plan will inform the CAA review for Reference Period 3 UK performance plan and targets, including the NERL price control, for the period 2020 to 2024.

### Views invited

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We welcome views on all the issues raised in this document. Responses should be sent to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) no later than 5pm on 10 November 2017. We cannot commit to take into account any representations received after this date.

We are keen to engage with anyone interested in the future regulation of NERL. If you would like to discuss the issues raised in this document, please contact Bronwyn Fraser on [bronwyn.fraser@caa.co.uk](mailto:bronwyn.fraser@caa.co.uk) or on 020 7453 6291.

Representations received in response to this document will be made available on our website unless they are explicitly marked as "confidential". Where responses are sent by email, any material considered confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to disclosure of information under Schedule 9 of the Transport Act 2000 and the Freedom of Information Act 2000, and it may be necessary for us to disclose information received consistent with these requirements.

## Introduction and summary

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1. NATS (En Route) Plc (NERL) provides en route (both domestic and Oceanic) and certain approach air traffic services in the UK. As a monopoly, it is subject to economic regulation under the European Union's (EU) Single European Sky (SES) Performance Scheme for Air Navigation Services, which provides for the setting of targets and incentives to drive performance, and the Transport Act 2000 which sets a broader regulatory framework.
2. In April 2017 we published a discussion document setting out our proposed strategic outcomes for the regulation of NERL for the next reference period, Reference Period 3 (RP3), which runs from January 2020 to December 2024.
3. We are now consulting on guidance to NERL for the preparation of its business plan for RP3. Following this consultation we will update and confirm our guidance to NERL in January 2018, ahead of NERL producing its initial business plan (IBP) for customer consultation by March 2018.
4. In autumn 2018, following customer consultation, NERL will provide a revised business plan (RBP) that we will use to inform the development of the performance plan and targets for NERL in RP3.

## Purpose and approach

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5. This document:
  - Provides feedback on our April 2017 discussion document '[Strategic Outcomes for the Economic Regulation of NERL 2020-24](#)' (CAP 1511);
  - Consults on our approach to RP3 business plan guidance for NERL; and
  - Consults on our guidance on customer consultation.
6. To align with the timetable set down by the European Commission (EC), NERL must prepare a business plan in early 2018 that relates to the period 2020-2024. Some of the key future requirements for NERL during RP3 are likely to evolve over time. Therefore, it is important that our approach has a degree of flexibility that can accommodate such changes so they can be funded and appropriately incentivised, while respecting the timetable for developing the proposals for RP3 and allowing time for consultation on NERL's plans.
7. NERL should own and justify the key assumptions underlying its business plan and only where there are good reasons for detailed regulatory guidance on assumptions should we make exceptions to this approach. This is a different

approach to Reference Period 2 (RP2 – 2015-2019), where we provided a number of detailed assumptions and targets as guidance to NERL in preparing its business plan.

8. It is important that NERL rises to the challenge of producing a well evidenced business plan that wins both our confidence and that of other stakeholders. In this context an unnecessarily interventionist approach by the CAA at an early stage may distract NERL's attention and focus from establishing a persuasive and well evidenced vision for the services it provides to its customers, passengers and other stakeholders.
9. Nonetheless, certain higher level guidance may be appropriate (in particular relating to scope and issues to be covered) and it is important that NERL understands our broad expectations for its business plan and our expectations as to the sort of evidence the business plan should contain. First and foremost, NERL's plans need to deliver safe and resilient services for users. We are also proposing that NERL adopts a **two track approach** to the development of its business plan. This reflects the significant developments in and requirements from air traffic management and airspace – among other considerations – in the RP3 period and beyond. Faced with the differing stages of development and the nature of the issues to be addressed, we expect NERL to develop:
  - A baseline business plan incorporating known and expected requirements – 'core' requirements; and
  - Supplemental information setting out incremental effects on costs, and performance generally, of less certain changes that are likely but less certain – 'wider' requirements.
10. Adopting this two track approach should allow NERL to progress with the development of its business plan, while providing an opportunity to take into account the impact of wider issues as they mature. We also provide high level guidance on outcomes and outputs, costs and financeability issues.

## Feedback on strategic outcomes

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11. CAP 1511 proposed the following strategic outcomes for the regulatory review of NERL's activities in RP3:
  - Effective accountability mechanisms – in particular in the context of better business planning and delivery, and providing for a leading role for NERL in respect of modernising the UK airspace architecture;
  - Efficient prices; and

- Service quality improvement – in particular in respect of resilience and a broader view on the environment to include the impact of noise.
12. Stakeholders generally supported the strategic outcomes set out in CAP 1511 for guiding the development of the regulatory framework for NERL. Nonetheless, stakeholders raised a number of specific issues of concern, including concerns regarding the governance of the capital programme given the decision to delay the London Airspace Management Programme (LAMP2) in RP2. Where appropriate these issues are highlighted in this document.
  13. Several stakeholders (including NERL) suggested that safety should also be a strategic outcome. While safety was not explicitly presented as a strategic outcome in CAP 1511, we said that all of NERL's activities should always be in the context of maintaining safety. To be clear, it is our expectation that NERL will develop its business plan taking full account of its own safety obligations, demonstrating how it is maintaining safety and where it plans to improve its safety performance.
  14. The Transport Act 2000 gives the CAA a primary duty to exercise its functions so as to maintain a high standard of safety in the provision of air traffic services; it also places a duty on NERL, as the licence holder, to provide a safe system for air traffic services. The EU SES regulations also emphasise the importance of safety.
  15. Bearing the above in mind, our view is that safety should not be a separate strategic outcome as it should be a pervasive feature of NERL's business plan and its central focus, where appropriate supported by carefully thought through indicators and metrics such that its safety performance is both robust and transparent. The CAA considers that NERL's pursuit of economic and service quality performance outcomes can never be at the expense of safety.
  16. We received eight responses to CAP 1511 from a range of different stakeholders. These responses are published in full on the CAA website. Comments in relation to safety have been addressed above. Other comments that relate to business plan guidance or customer consultation are dealt with in the following chapters of this document. A brief summary of responses is set out below (a fuller summary of responses to CAP 1511 is set out in Appendix C):
    - British Airways and Virgin Atlantic Airways highlighted the importance of delivering LAMP2 in RP3, and considering noise alongside new capacity and costs for airspace users;
    - Gatwick Airport Limited's (GAL) response raised a number of issues, including the need for engagement with airport operators as stakeholders and strategic leadership from Government on airspace design. Biggin Hill Airport Limited (BHAL) indicated it wanted to be included in the scope of the London Approach service;

- A resident overflown by aircraft using Heathrow Airport also highlighted noise as an issue, stating NERL should take into account the interests of affected communities;
- NERL's response sought to address a wide range of issues for RP3, highlighting the significance of airspace change while highlighting its desire for a performance plan that is safety and service led;
- The Prospect Air Traffic Control Officers' (ATCO) Branch's response indicated its hope that RP3 would remedy its concerns from RP2, including perceived CAA sensitivity to airline pressure to cut costs; and
- The response from the trustees of the NATS pension scheme stressed the importance of retaining an ongoing stable and predictable treatment of NERL's defined benefit pension scheme.

## Outcomes and outputs

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17. In CAP 1511 we noted that the quality of services (strategic outcome three) provided by NERL across all its activities was very important for airspace users, while also providing a safe and efficient service as an essential minimum requirement. We also stressed the importance of ensuring effective mechanisms to hold NERL to account for delivery (strategic outcome one). Minimising the impact of delay on airspace users and mitigating the impact of aviation on the environment are also important, both for those that benefit from air navigation services and those that are impacted by actions of Air Navigation Service Providers (ANSPs).
18. In developing its RP3 business plan, NERL will need to consult both with its customers as well as understanding the requirements of passengers and overflown communities. We expect that NERL's business plan will address:
  - The need for a safe service;
  - Delay performance for its key licensed activities establishing challenging targets for RP3, in the context of understanding traffic evolution, high quality data and customer requirements;
  - Flight efficient routeing and the noise impact of air navigation services – including understanding where improving flight efficiency performance improvements might lead to adverse noise impacts on communities and developing mitigation proposals;



- Technical and operational resilience – understanding and providing the appropriate level of systems resilience to achieve a high level of network performance even as it deploys new Air Traffic Management (ATM) technologies, and ensuring it has in place robust procedures and processes to identify and plan for future operating requirements. This should also reflect any changes that are necessary by way of learning from the CAA’s recent investigation of NERL’s performance at Stansted Airport following complaints made by Ryanair and Stansted Airport Limited; and
  - Developments in airspace use and architecture – for example, how NERL will continue to safely and efficiently manage existing airspace users as new classes of airspace users look to operate near and in the same airspace, and exploring NERL’s role in the delivery of a modernised airspace architecture.
19. Core requirements which drive service quality in respect of capacity, resilience and the environment should be incentivised appropriately. NERL should set out proposals for incentives (both financial and non-financial) in its business plan.
20. NERL should clearly set out in its business plan how wider requirements could influence outcomes/outputs, costs and consider possible incentive mechanisms (including those relating to airspace change).

## Costs

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21. As discussed in CAP 1511, delivery of efficient prices (strategic outcome two) will include establishing efficient cost estimates, as well as governance processes and incentives to respond to changes in requirements during the reference period.
22. We expect that in developing its RP3 business plan, NERL will demonstrate that its proposed costs (both capital and operational) are efficient using appropriate benchmarking.
23. The significant change to the original capital expenditure (capex) programme early in RP2, where the focus switched from airspace change to replacement of legacy systems, highlights the key requirement for NERL to establish with customers transparent and effective consultation and governance mechanisms (in accordance with strategic outcome one) for the management of the capex programme. These mechanisms are not only in relation to developing a high quality, credible and cost efficient capital programme for the start of RP3, but that are able to respond to changes in the operating environment, user requirements and policy during the reference period. NERL should also consider how its capital programme should be managed and incentivised over multiple reference periods.

24. It is important that NERL's total costs are efficient, and that its business plan identifies the appropriate balance between capital and operating costs. This review also provides the opportunity to consider whether the costs and allowances for the Future Airspace Strategy (FAS)<sup>1</sup> Deployment Facilitation Fund (FFF) are reasonable and efficient.
25. The cost of NERL's pension obligations is a significant component of its cost base and a key issue identified by respondents to CAP 1511. In developing its business plan, NERL will need to provide:
  - Compelling evidence that it has behaved and is continuing to behave in a manner consistent with a commercially minded company; and
  - That it has taken all steps available to it within its legal discretion to manage and mitigate the pension cost burden on airspace users.
26. We expect that pension deficit costs, as they relate to past service, will all be identified as core costs, whereas ongoing pension costs, because they relate to future service, may be shown as both core and wider costs.

## Financeability

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27. In delivering efficient prices, a key consideration for the CAA and NERL is that the resulting performance targets and service quality incentives do not make it unduly difficult for NERL to finance its licensed activities.
28. NERL should develop its own proposals with respect to the level of allowed profit through the Weighted Average Cost of Capital (WACC) and the Regulatory Asset Base (RAB). In doing so we would expect NERL to base its business plan on a well evidenced view of an efficient WACC.
29. We expect to publish an early and preliminary range for Heathrow Airport Limited's (HAL) WACC in December 2017. NERL should have regard to the information that is provided on market wide elements of the cost of capital in developing its proposals for its WACC.
30. NERL should also set out the other evidence that it regards as necessary and appropriate to demonstrate that its business plan is efficient and financeable, including the credit metrics that would allow it to continue to access debt finance on reasonable terms.
31. The level of regulatory depreciation is expected to fall during RP3 as the assets at privatisation are fully depreciated, and this may impact on revenues and cash

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<sup>1</sup> The Future Airspace Strategy sets out a vision to modernise UK airspace and use technology to make it fit for the 21st century. See: <http://futureairspace.aero/>

flow. If this or other issues (such as pension deficit recovery costs) raise issues for financeability, NERL should explain how these matters can be best addressed efficiently, while continuing to deliver affordable services for its customers.

## Customer consultation

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32. NERL's customer consultation in previous regulatory reviews has focused on airspace users. Bearing in mind our expectation that NERL will have a significant role in the development of South East airspace change we consider that airspace users and airports should be consultees for its business plan.
33. We are also interested in stakeholders' views on whether NERL's RP3 consultation processes should be based on those adopted for RP2 with incremental changes to deliver improvements, or whether more fundamental changes and/or an alternative model may be appropriate.
34. Wider policy issues of resilience and noise have direct impacts on final consumers (i.e. passengers), and affected overflown communities. We expect NERL to carefully consider the way in which it engages to understand the views of these stakeholders.
35. To facilitate development of the RP2 performance plan we published several consultancy reports to help inform both stakeholders' and our views. We intend to conduct research to scrutinise NERL's RP3 business plan. In response to feedback on the RP2 process and CAP 1511, we are currently planning to commission some aspects of this work earlier in the process than was the case for RP2, to coincide with and inform the customer consultation process.
36. We are interested in stakeholders' views as to the proposed CAA consultancy studies as set out in Appendix D.

## Our duties

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37. In developing our proposed approach and policies in this document we have had full regard to our duties under the Transport Act 2000 and functions as a national supervisory authority under the SES Performance Scheme, both of which are summarised in Appendix A.

## Proposed timetable and next steps

38. Our programme is, to a significant extent, driven by the need to align with the EU process to develop the regulatory framework and targets for the RP3 period. The current high level milestones are summarised below:

Milestone	Indicative dates
NERL customer consultation on its initial business plan	April – September 2018
EC adoption of revised regulations for RP3 and adoption of EU targets <sup>2</sup>	June 2018
NERL submission of revised business plan	October 2018
CAA consultation on draft RP3 performance plan	January – March 2019
Department for Transport (DfT) adoption of RP3 performance plan and submission to the European Commission	June 2019
European Commission assessment of performance plans	July – November 2019

39. CAA consultancy studies will be scheduled throughout 2018 in response to key deliverables - see Chapter 5 and Appendix D for further details.

## Structure of this document

40. The structure of this document is as follows:
- **Chapter 1** outlines our proposed high level approach to RP3 business plan guidance for NERL
  - **Chapter 2** sets out draft guidance to NERL on outcomes and outputs
  - **Chapter 3** provides draft guidance to NERL on the efficient costs necessary to deliver the outcomes and outputs
  - **Chapter 4** provides draft guidance to NERL on demonstrating financeability
  - **Chapter 5** sets out our proposed approach to customer consultation
  - **Appendix A** sets out our duties under the Transport Act 2000 and role as national supervisory authority under the EU SES Performance Scheme

<sup>2</sup> The current SES Performance regulation requires EU targets to be adopted no later than 12 months before the start of the Reference Period – i.e. December 2018, however the EC has indicated that it intends to adopt the EU targets by June 2018.

- **Appendix B** provides a list of all the consultation questions
- **Appendix C** summarises the responses to CAP 1511
- **Appendix D** sets out the proposed CAA consultancy studies for RP3 in terms of objectives, scope and deliverables
- **Appendix E** provides an overview of the building block approach

## Chapter 1

# Approach to RP3 Business Plan development

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- 1.1 This chapter sets our proposed approach to RP3 business plan guidance to NERL. It sets out a framework for how we expect NERL to address requirements that are not expected to be well defined before NERL submits its business plan – a two-track approach – and provides an update on EU context and milestones.

## CAA approach to guidance

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- 1.2 Our key principle is that NERL should own and justify the key assumptions underlying its business plan and only where there is a compelling reason for detailed regulatory guidance should an exception be made to this approach. This is different to the approach to RP2, where we provided a level of detail in published correspondence between CAA and NERL as part of the RP2 business plan development process.
- 1.3 NERL should be able to rise to the challenge of producing a well evidenced business plan that will gain both our confidence and that of other stakeholders. In this context an unnecessarily interventionist approach by the CAA at an early stage may distract NERL's attention and focus from establishing a persuasive and well evidenced vision for its business plan and the services it provides to its customers, passengers and other stakeholders.
- 1.4 In considering the form and scope of their business plan we expect NERL to take account of requirements under both the current regulatory framework, and any developments that emerge in respect of the SES RP3 framework, as well as meeting stakeholders' expectations. In doing so, NERL should set out its justifications and rationale for the assumptions and parameters it proposes, given its overall vision for RP3.
- 1.5 We expect NERL's business plan to cover the regulated activities under its Air Traffic Services Licence, in particular the UK En Route and London Approach services under scope of the EU and domestic regime; as well as the Oceanic service, which is subject only to the domestic regime. In particular, in relation to the London Approach service, we expect NERL to consider the allocation of costs between London Approach and En Route, the airports within scope and level of granularity it provides in terms of service quality measures.
- 1.6 Where appropriate and in line with our key principle above, more detailed guidance is proposed in the remainder of this document.

- 1.7 Given the future impact of Brexit and that the SES regulatory framework for RP3 is subject to review and change, it is not yet known what requirements might be in respect of development of a UK-Ireland Functional Airspace Block (FAB) performance plan for RP3. Where this turns out to be the case, and where appropriate, references to the UK performance plan should be construed as the UK-IE performance plan and that CAA will work with the Irish Aviation Authority's Safety Regulation Department accordingly.
- 1.8 In terms of the broader implications of Brexit on the development of the RP3 performance plan, and therefore guidance to NERL in developing their business plan, our view remains that there will be similar substantive regulatory requirements. If the institutional arrangements change, whether the UK is under the European or domestic legislative framework, we expect to produce a price cap and service quality targets that go towards achieving the strategic objectives above and CAP 1511, irrespective of the regulatory framework in place.

## Two track approach

- 1.9 We are conscious that there are certain issues that may require funding from NERL's RP3 price control revenue, particularly in respect of the strategic outcome on effective accountability mechanisms, that could be important for NERL, its customers and consumers more generally, but that are at an early stage of development. These include airspace modernisation and certain new technologies.
- 1.10 Faced with these challenges, the CAA proposes NERL adopt a two track approach to developing its business plan. This approach should include the following two elements:
- A baseline business plan incorporating known and expected requirements – “core” (e.g. delay targets); and
  - Supplemental information setting out the incremental effects on costs and performance of less certain requirements and possible future developments – “wider” (e.g. airspace architecture modernisation).
- 1.11 This approach should allow NERL to make progress with the development of a business plan that is fully costed, safety focused, well justified and high quality. It allows NERL to set out how it will deliver the activities characterised as “core”, while providing an opportunity to account for possible future developments of the “wider” considerations. These may include:
- the potential future role of NERL in modernisation of airspace architecture; considering what role NERL might have in the development of any airspace masterplan and how this might impact on their operations in RP3 and beyond;

- potential cyber security obligations in accordance with developing Government policy – taking account of obligations that might arise from the EU Network and Information (NIS) Directive;
- responding to the introduction of new and potentially disruptive technologies (for example, drones) in a way that leads to positive outcomes for consumers - considering the possibility that the introduction of new technologies allow for the development of and significant changes to ways of operating; and
- responding to developments in relation to Brexit.

1.12 We expect NERL to:

- clearly identify in its business plan both the “core” and “wider” considerations required to meet the established strategic outcomes;
- set out where there are a range of options to deliver capacity, resilience, environmental and safety performance. In doing so, NERL should clearly articulate its particular requirements and costs as being either “core” or “wider”, along with its rationale for why they consider them to be so; and
- identify its preferred option.

1.13 Chapters 2 to 4 of this document provide, for consultation, draft guidance to NERL in respect of outcomes, costs, and financeability, with indicative views of “core” and “wider” considerations.

## Other matters

1.14 We expect NERL to take care to clearly justify the assumptions it uses in its business plan and make forecasts of the efficient costs necessary to deliver outputs and outcomes. NERL should take account of requirements under both the current regulatory framework, and any developments as they emerge in respect of the SES RP3 framework. It should use a building block approach (as summarised in Appendix E) to establish levels of required revenue, and present costs information as clearly, transparently, and on an as consistent basis as possible to support effective stakeholder engagement. In particular, in relation to:

- Military and other activities included in the single till;
- Treatments of total and chargeable service units;
- Use of calendar years and choice of inflation indexation; and
- Use of a consistent price base.

1.15 NERL should use the traffic (including service units) and economic forecasts it thinks most appropriate, justifying them accordingly, mindful of existing regulatory requirements.



- 1.16 It should propose and justify the start point it uses for cost efficiency calculations, ensuring data are presented in a way that enables ready comparison and analysis of performance with previous reference periods. NERL should be clear on its treatment of true-ups between reference periods in relation to costs, but should also provide information on the impact of such true-ups will have on charges.

## EU context and timetable update

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- 1.17 In March 2017 the EC set out certain options for the revision of the two SES performance regulations – the performance regulation and the charging regulation.<sup>3</sup> Following a period of written consultation with Member States and industry stakeholders, the options and consultation responses formed the basis for an impact assessment study.
- 1.18 The preliminary results of the study are expected in autumn/winter 2017 shortly followed by draft legislative proposals. The EC timeline also includes a period of open consultation on the proposals before their adoption. The text should be available on the EC's Better Regulation<sup>4</sup> portal in the first half of 2018.
- 1.19 The EC also initiated a specific study on incentive schemes, the results of which are expected to be published in October 2017.
- 1.20 It is understood that once the process for adopting the new performance and charging regulations is sufficiently mature, parallel work will be carried out on proposals for EU-wide performance targets. The latest EC timeline indicates a parallel adoption of the new regulations and the decision on targets in mid-2018.
- 1.21 In its preparation for RP3, the EC is supported by the Performance Review Body (PRB) which is an advisory body of experts. The PRB is expected to drive the proposals for EU-wide targets and eventually carry out the assessment of RP3 performance plans once they are adopted by Member States.
- 1.22 Subject to an EC decision, there may not be a requirement to produce a FAB plan with Ireland for RP3, as was the case for RP2.
- 1.23 We continue to provide input to the development of the revised regulations to ensure, as far as practicable, that they are consistent with the UK's strategic outcomes for the future economic regulation of NERL.

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<sup>3</sup> COMMISSION IMPLEMENTING REGULATION (EU) No 390/2013 of 3 May 2013 laying down a performance scheme for air navigation services and network functions and COMMISSION IMPLEMENTING REGULATION (EU) No 391/2013 of 3 May 2013 laying down a common charging scheme for air navigation services.

<sup>4</sup> [https://ec.europa.eu/info/law/better-regulation/have-your-say\\_en](https://ec.europa.eu/info/law/better-regulation/have-your-say_en)

## Consultation questions

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1. Do stakeholders consider that a two track approach to NERL's business plan is reasonable?

## Chapter 2

# Outcomes and outputs for RP3

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- 2.1 This chapter sets out draft guidance to NERL on its RP3 business plan in respect of outcomes and outputs, largely driven by safety and the strategic outcomes of effective accountability mechanisms and service quality improvement.
- 2.2 As per the two track approach set out in chapter 1, we focus below on a number of key areas for consultation, setting out our initial thoughts on guidance in respect of the allocation of activities and outputs between core and wider requirements. Subject to stakeholder feedback to this consultation we may refine our thinking on guidance in these areas.

## Overall approach and key areas

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- 2.3 In CAP 1511 we said that the quality of services provided by NERL across all its activities was very important for airspace users. Minimising the impact of delay on airspace users and their customers is an important aspect of NERL's service delivery, in the context of providing a safe and efficient service. Environmental performance (both in terms of taking account of fuel efficiency and the noise experienced by overflown communities) is also important. The responses received to CAP 1511 were generally supportive of our proposals to take a wider, more strategic approach to service quality, extending beyond capacity and delay to include resilience and environmental issues and ensuring effective accountability mechanisms.
- 2.4 As we have explained in the introduction and summary to this document NERL's focus in delivering outcomes and outputs should always be in the context of maintaining safety. It is our expectation that NERL will develop its business plan taking full account of its own safety obligations, demonstrating how it is maintaining safety and where it plans to improve its safety performance.

## Capacity

- 2.5 Delays are traditionally measured by Air Traffic Flow Management (ATFM) delay metrics. There are established and understood measures of delay performance set out in the existing economic regulatory frameworks. As a core requirement, we expect NERL to:

- establish challenging and affordable targets for RP3, in the context of the provision of a safe service, using high quality data and analysis to understand historical trends, traffic evolution, and customer requirements. In doing so, NERL should set out any concerns it has with the current measures, identifying and justifying any proposed changes;
- provide appropriate traffic forecasts as the basis for calibrating these targets, explaining and justifying the basis for these forecasts; and
- conduct sensitivity analyses of the impact of higher and lower traffic levels at magnitudes it believes credible, justifying their rationale.

2.6 In RP2, NERL's capacity performance was addressed only at the en route level. The CAA's 2017 Project Oberon investigation<sup>5</sup> identified that a more granular view of NERL's performance across its various activities, in particular the London Approach service, would enable the earlier identification of potential performance issues. As a core requirement we expect NERL to establish metrics, targets, forecasts and conduct sensitivity analyses consistent with the requirements for en route, making appropriate modifications to align with the nature of the London Approach service. In developing metrics for the London Approach service, NERL should review the scope of the service – i.e. the airports to which approach services are provided – and whether there have been any developments since the last regulatory review that would merit further consideration.

## Resilience

2.7 Resilience is fundamental to ensuring capacity performance and includes:

- technical resilience, which refers to the robustness of systems and dealing with technical failures; and
- operational resilience, which refers to the robustness of planning and procedures to address the operational demands of providing services.

2.8 **Technical resilience** – as a core requirement we expect NERL to:

- ensure it understands and provides the appropriate level of systems resilience to achieve a high level of network performance, including as it safely deploys new ATM technologies; and
- consider the appropriateness of current performance and incentives and suggest improvements where appropriate.

2.9 **Operational resilience** – CAA's review of the operating resilience of the UK's aviation structure and the consumer interests<sup>6</sup> identified planning and scheduling

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<sup>5</sup> [CAP 1578 - Investigation under section 34 of the Transport Act 2000: Project Oberon.](#)

<sup>6</sup> [CAP 1515 - Operating Resilience of the UK's aviation infrastructure and the consumer interest.](#)

risks that could be addressed through NERL action in relation to capacity oversight, assessment and advice to airports and airlines.

2.10 The Project Oberon investigation recommended that NERL enhance its systems and processes so that it is better able to forecast potential shortfalls in ATCO supply; conduct more rigorous analysis of risks and issues that can impact a service; enhance its systems and processes for contingency planning. As a core requirement, we expect NERL to:

- ensure it has in place robust procedures and processes to identify and plan for future operating requirements;
- take into account the Project Oberon recommendations; and
- develop the means to perform a capacity oversight, assessment and advice function to advise airports and airlines of the opportunity to make early decisions between accepting delay or re-routes where there are particular hotspots.

2.11 In April 2017 a group of airports and airlines, along with NATS, Airport Coordination Limited (ACL) and the CAA, formed the Voluntary Industry Resilience Group (VIRG) to pool their expertise and recommend actions, for industry itself or the Government's review of Aviation Strategy) to address current and future resilience issues. As a wider requirement, we expect NERL to take account of relevant recommendations by the VIRG in developing its RP3 business plan. For example, in relation to NERL's potential network-wide role in improving situational awareness, operational coordination and decision making.

## Environment

2.12 Environmental performance in ATM has traditionally focussed on measures of flight efficiency, as a proxy for carbon emissions. Currently, NERL is incentivised to provide optimal flight paths that minimise emissions, and thus fuel burn, using a measure of horizontal and vertical flight efficiency known as 3Di. We have previously stated our expectation that the 3Di model, which is based on sample data, will move towards using actual flight data to better reflect operational developments. As a core requirement we expect NERL to:

- reflect the principles of using past performance trends to establish challenging targets going forward in the context of understanding traffic evolution, supported by high quality data and knowledge of customer expectations;
- take into account improvements in data, anticipated operational improvements and factors that can affect performance; and
- propose any modifications to the 3Di model and draw out factors that could have a significant operational and performance impact.

- 2.13 **Noise** – In CAP 1511 we said that we were open minded about the approach NERL should take in responding to public expectations around noise where there is potential for its actions to impact overflowed communities. Stakeholder responses highlighted some appetite for broadening the view of environmental performance to take into account noise. Given the importance of these matters, NERL should explore these issues further in its business plan. As a core requirement, we expect NERL to:
- consider opportunities to develop means to measure the impact its actions have in relation to noise and overflowed communities; and where practicable, to identify appropriate incentives, in light of the SES Charging Regulations and principles;
  - set out why its proposed approach best supports strategic or consumer outcomes and to clearly articulate the rationale behind its proposals; and
  - identify how to balance incentives for flight efficiency performance with minimising the impact of, and where possible reducing, noise experienced by overflowed communities.
- 2.14 The CAA has been reviewing and reforming its airspace change decision making process, which includes making the process more transparent, improving the stakeholder engagement required, and improving the evidence base used. The Government's forthcoming consultations on the Aviation Strategy will also consider the way in which noise impacts are understood and mitigated, and how noise should be considered as part of a strategic modernisation of airspace across the UK.
- 2.15 As a wider requirement, we expect NERL to:
- meet the new policy and regulatory approach mentioned above; and
  - explore and consider opportunities to directly measure its noise performance and, where appropriate, deliver tangible noise reductions.

## Airspace

- 2.16 In CAP 1511, we said that the implementation of the second phase of LAMP2 and airspace change is needed for the successful development of a third runway at London Heathrow.
- 2.17 LAMP2 will be a challenging and complicated programme and is likely to require decisions about the competing priorities of London airports for airspace. Implementing the technology and supporting operational systems are clearly a core activity for NERL. Airspace change raises a broader set of issues.
- 2.18 At present there is no single party responsible for a vision or plan that looks at airspace in the round. Given the nature of the decisions needed, further work is required by DfT, the CAA, and industry to enable and secure the delivery of

interrelated airspace changes, and to create a comprehensive suite of mechanisms to ensure appropriate airspace changes are made.

- 2.19 Given that it houses a large concentration of relevant technical expertise, and that airspace modernisation is linked to its current licensed activities, it is likely that NERL will have a key role in the development and the delivery of new plans and change arrangements. Albeit within a framework that addresses many of the strategic considerations involving wider political judgments on noise and the allocation of airspace between users and airports.
- 2.20 We expect NERL to:
- consider delivery of LAMP2 as a core requirement; and
  - take account of a greater coordination and delivery role in change arrangements in the wider requirements section of its business plan, explaining the assumptions underlying these activities.

## Cyber security

- 2.21 Cyber security is an increasingly important consideration for industry and individuals alike.
- 2.22 NERL should already have arrangements in place to ensure protection, safety and service continuity in respect of cyber security threats as part of its business as usual activities. We expect these to be reflected as core requirements in its RP3 business plan, along with suitable information and justification for their inclusion. Where NERL expects any additional requirements to arise from the recent EU Network and Information Systems Directive and associated implementing legislation, NERL should consider these as wider requirements, providing suitable justification and information as to why they might not be considered core requirements.

## New technologies

- 2.23 New technologies offer opportunities and poses challenges for NERL in fulfilling their role in airspace management. To the extent that there are choices available to NERL as to what technology they will deploy in RP3, these choices should be reflected in their business plan and NERL should explain how these various options will enhance safety and meet strategic outcomes, and how they fit into the core and wider framework. The adoption of new technologies is expected to be necessary for NERL to effectively provide services in RP3 and beyond.
- 2.24 Drone-related safety issues were raised in responses to CAP 1511 and recent developments around ensuring the safe operation of this new technology.<sup>7</sup> The

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<sup>7</sup> For example “Drones to be registered and users to sit safety tests under new government rules” published

CAA is expecting to work with the Government to establish clearer guidelines on airspace management with relation to drones to ensure the safety of airspace users.

2.25 Under Condition 10(6) of its Air Traffic Services licence, NERL is required to produce an outline technology plan covering the RP3 period by 20 June 2018. As a core requirement, we expect NERL to:

- continue to safely and efficiently manage existing airspace users, as new classes of airspace users look to operate near and in the same airspace;
- be proactive in implementing new technologies to mitigate safety risks and improve cost efficiency where possible;
- set out options around potential improvements to be delivered through new technologies;
- set out the impact of drones that will impact on its business and costs for En Route and London Approach services and should be funded by airspace user charges;
- ensure consistency between the Condition 10(6) outline technology plan and its RP3 Business Plan. Where there are legitimate reasons for differences – for example, the emergence of new information over time – then we expect NERL to find a proportionate way to address these, such as in the engagement on its IBP.

2.26 It is possible that the introduction of new technologies allow for the development of and significant changes to ways of operating, especially with new classes of airspace users such as drones. This might include greater automation, or systemisation, or raise questions as to the scope of NERL's future business activities that should be considered as part of the airspace user funded monopoly activities under the price control. There may be opportunities to benefit from the creation of new markets in the provision of ATM and airspace management that lead to positive outcomes for consumers. As a wider requirement, we expect NERL to:

- develop and assess the choice of technology and incremental costs and benefits, where there is uncertainty as to whether a technology should be adopted as part of its licensed monopoly business;
- identify those activities it is assuming are part of the monopoly business and those activities that are not, and set out their rationale; and
- address innovative ways of operating that do not constrain the ability of the development of new technologies to deliver positive consumer outcomes.

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on 22nd July 2017 the GOV.UK website.



## Interactions between core and wider requirements

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- 2.27 The implementation of the wider requirements described above may impact on core requirements and their associated performance measures. Wider requirements may also require the development of new measures and targets to support the delivery of the outcomes. In developing its RP3 business plan, NERL should articulate which performance measures need to be modified or if new ones need to be developed, providing appropriate explanation and justification along with high quality metrics.

## Incentives

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- 2.28 The current incentive scheme is determined by the SES Performance framework and, as it relates to delay/capacity and environmental performance, is incorporated into the NERL licence.
- 2.29 In preparing its business plan, NERL should propose the incentive arrangements appropriate to support efficient and timely delivery for its customers and wider stakeholders. It should clearly set out how these could operate and any changes that would be necessary to align with the existing SES Performance framework. NERL may also suggest adjustments to the measurement of existing metrics, within the overall framework of the existing incentives, where duly explained and justified.

## Consultation questions

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2. Do stakeholders have views on the allocation of activities and outputs between the core and wider categories for NERL's business plan?
3. Are there any further views from stakeholders on extending the scope of the incentives on NERL to put greater emphasis on resilience and noise?

## Chapter 3

# Costs

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- 3.1 Efficient prices are an important strategic outcome. In delivering the RP3 outcomes and outputs discussed in chapter 2, NERL will need to develop plans that are consistent with the efficient delivery of its activities. Under the SES Performance Scheme, the cost of provision of air navigation services is met through charges to airspace users. These users, and ultimately consumers, want efficient and reasonable prices for aviation services.
- 3.2 This chapter provides draft business plan guidance to NERL on efficient costs including:
- how NERL should separate its costs to the core and wider sections of its business plan on the basis of the two track approach;
  - processes and considerations regarding the delivery of efficient capex;
  - key considerations in relation to operating costs (opex) and ensuring the business plan takes account of safety and overall efficiency in the longer term; and
  - NERL's pension costs, which are substantial and include pension deficit recovery costs.
- 3.3 The main themes in this Chapter are consistent with what we set out in CAP 1511, but also include the two track approach. In particular, in developing its business plan NERL should:
- separate its activities and costs into core and wider sections of the business plan, with core costs reflecting those of a standalone business and wider costs being only additional incremental costs;
  - demonstrate its plans are consistent with a reasonable level of ongoing efficiencies, including by benchmarking;
  - develop a capital programme that is supported by clear and compelling cost benefit analyses and strategic optioneering;
  - develop meaningful options for airspace users to consider that explore the balance between price and service/resilience trade-offs;
  - take into account a number of scenarios with regard to key economic drivers such as traffic levels; and
  - develop plans that will deliver a balance between value for airspace users (and ultimately consumers) on one hand, and affected communities on the other, in relation to airspace reform and environmental improvements.

## Capital expenditure

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- 3.4 In relation to NERL's capital programme, the main themes and associated responses to CAP 1511 covered:
- that more effective mechanisms for investment programme oversight should be established for RP3, including a review of how successfully current arrangements governing NERL's Service and Investment Plan (SIP) have been in incentivising efficient investment;
  - how best to manage changes in the scope and/or cost within the reference period, especially given the need for airspace modernisation and the postponement of LAMP2 early within RP2; and
  - whether better financial incentives, reporting requirements or licence conditions are required to help encourage capital efficiency.
- 3.5 In addition, the May 2017<sup>8</sup> Independent Reviewer<sup>9</sup> highlighted that confidence in the deliverability of the programmes would have been higher if NERL had confirmed that its submitted plans were robust enough to survive future variations in fuel prices and traffic, and robust to an appropriate range of different scenarios. This applies equally to core and wider requirements.
- 3.6 Responses to CAP 1511 suggest it may be appropriate to improve transparency and increase the degree of scrutiny of NERL's decisions on its capital programme. This could require significant changes, such as:
- changing how the SIP process works and the role of this process in the regulatory framework; and/or
  - reviewing the role of the Independent Reviewer and how they might input into capex reviews and additions to the asset base.
- 3.7 NERL will need to consider whether improved governance arrangements and incentives are appropriate in its business plan. One source of information that NERL should draw on in considering these matters is the report produced by

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<sup>8</sup> [NATS \(En Route\) plc Airspace & Technology Programmes 2017: Independent Reviewer Report May 2017](#)

<sup>9</sup> Condition 10 (Business Plans, Service and Investment Plans and Periodic Reports) of the NERL licence provides for the CAA to appoint an Independent Reviewer to review the accuracy of NERL's reporting under this Condition. Grant Bremer of Chase Partners Ltd was appointed as the Independent Reviewer in September 2016.

Arup and Helios<sup>10</sup> which identified the areas where NERL should be providing more information on its capex plans, including:

- transparency of costs underpinning the programme, including the reasons for variances and clear traceability from programmes to individual projects;
- improved visibility and granularity of benefits and outputs, enabling the incremental impact of programme / sub-programme / project elements to be better understood;
- stronger evidence around investment cost efficiency, particularly in relation to internally procured projects;
- harmonisation and clearer linkage of programme activities, costs and benefits between regulatory periods, with a consolidated overview of programme elements, their delivery timescales, costs, cross-linkages and benefits; and
- consistency in the metrics utilised for benefits and outputs measurement – to allow for a common form of measurement across regulatory periods.

3.8 We expect NERL's business plan to take steps to address the above feedback. This includes both providing the appropriate level of granularity and transparency of its capital plans, which should be supported by compelling strategic optioneering and cost benefit analyses. NERL should also set and justify any adjustments it is proposing to its RAB or RP3 revenues to take account of variances from its RP2 capital allowances and actual capex. It should provide evidence that it has adopted a consistent and reasonable approach to capitalisation policy in calibrating these adjustments.

## Operating costs

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- 3.9 Opex includes non-capitalised staff costs and certain other costs such as facilities management, non-operational IT, asset management and business support. Two important areas that contribute to opex but are discussed separately below are the costs of the FFF and pensions.
- 3.10 Although we are discussing separate categories of costs it will be important that NERL's business plan identifies costs consistent with overall efficiency, including taking proper account of safety and the outcomes and outputs that customers are willing to fund and are affordable.
- 3.11 We expect NERL's business plan to provide an appropriate level of evidence that its cost forecasts are efficient, including its estimates of costs associated with activities allocated to the wider section of its business plan. This means that the plan should provide sufficient detail on the outcomes and outputs that are

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<sup>10</sup> <http://www.caa.co.uk/natslicence/> - NERL RP2 Capex Review Arup and Helios Phase 1 Report

expected to be delivered, including the strategic optioneering and cost benefit analyses of programmes and/or individual projects. We expect to see evidence that NERL's proposed unit costs are efficient. Where possible, this should be informed by benchmarking, including against other industries (e.g. for corporate functions).

- 3.12 Given the need to provide a baseline level of efficient cost associated with the core requirements, we expect NERL to only focus on incremental costs for wider requirements. Justification of those wider costs and evidence clearly demonstrating that there is no double counting of overheads or fixed costs should be included in the IBP.
- 3.13 A FFF was established in the RP2 performance plan. This reflected the significant benefit to airspace users of large elements of the FAS programme, the high levels of dependency and uncertainty associated with deploying FAS-related projects and the potential for misalignments between the costs and benefits of small but important aspects of the FAS programme that might deter some third parties from investing where and when required (see our publication [CAP1249](#) for a fuller explanation of these matters). The fund is financed through the NERL component of the UK's en route unit rate.
- 3.14 Given the ongoing questions around airspace development, NERL should consider and explain in its IBP whether the FFF continues to be needed for RP3 and, if so, at what level. NERL and other stakeholders should also comment on whether the current governance arrangements around the FFF are appropriate for the future. NERL should explain whether its forecasts of these costs are sufficiently certain to warrant inclusion in the core section of its business plan, or whether they should be allocated to the wider section.

## Pensions

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- 3.15 Pension obligations are a significant component of NERL's cost base and are expected to be substantial in RP3 and so the regulatory and business plan treatment of these costs is important. A significant driver within NERL's pension costs over RP3 will be the expected deficit in the Defined Benefit (DB) pension scheme. In CAP 1511 we noted that at the last valuation the deficit was measured at £459 million as at December 2015 (about 9% of Scheme liabilities) and was equivalent to around 40% of NERL's RAB.
- 3.16 In CAP 1511, we identified a link between Trustees' confidence in the regulatory framework and the level of pension costs. Were the Trustees to lose faith in the regulatory framework, their perception of risk could rise and they might adopt a more cautious approach to pension deficit recovery, leading to higher costs in RP3. Both the CAAPS Trustees and NERL highlighted this relationship in their

responses to CAP 1511, with the NERL response identifying the pass-through provisions of the current SES framework as being especially important to the Trustees' perception of risk. Under the pass-through provisions, variations between actual and determined costs due to unforeseen changes in national pension law, pension accounting law, or unforeseen market conditions are passed through to customers.

- 3.17 Since 2008 NERL's DB Scheme has been in deficit, with airspace users bearing certain additional costs of deficit repair. In CAP 1511 we noted that airspace users should benefit if circumstances change and the pension scheme moves into surplus. In its response NERL agreed that its customers should benefit from reduced prices if financial market conditions change and this reduces the pension deficit or creates a surplus.
- 3.18 The above suggests that NERL's business plan should explain and provide evidence:
- how airspace users would benefit from any future pension scheme surplus (in particular in the circumstances where the surplus might not be wholly utilised through reduced employer contributions that flow back to customers through the pass-through arrangements);
  - those aspects of the regulatory framework that are necessary to provide sufficient certainty to Trustees so that they support a reasonable profile of pension deficit repair costs; and
  - how NERL proposes to include in customer charges for RP3 those pass-through adjustments arising from RP1 and RP2, and the process and evidence it has used to verify these adjustments.
- 3.19 In CAP 1511 we were clear that the overall level of pension costs that are finally allowed in setting the RP3 price control, as well as the application of pass-through provisions, depend on NERL demonstrating that it has done all it can to mitigate the burden on airspace users arising from the company's pension obligations. One example we are aware of is that the company has recently offered remuneration uplifts to employees in exchange for their foregoing rights to future pensionable service – an outcome which might be advantageous to both parties.
- 3.20 In regards to the efficient level of costs, we expect NERL to provide the following evidence in its business plan:
- that it has behaved and is continuing to behave in a manner consistent with a commercially minded company by taking all steps available to it within its legal discretion which are in the interests of users to manage and mitigate the pension cost burden on airspace users;

- it has considered and where appropriate taken actions consistent with those actions taken by other employers in the UK that do not benefit from the cost pass-through arrangements that have been available to NERL;
- that it has worked with the Trustees to take actions to help minimise future costs and how these compare with actions taken by other employers and Trustees of other schemes, including those in sectors of the economy subject to normal commercial and competitive pressure. NERL should also set out and explain the assumptions it has made about the Trustees' future actions, including evidence benchmarking these assumptions against the actions of Trustees operating schemes in sectors of the economy open to normal commercial and competitive pressures;
- identifying cash costs of the DB Scheme separately from those of the Defined Contribution (DC) Scheme, that the cash costs of the DB Scheme are separated between ongoing service and deficit repair and that its forecasts of this cost takes into account information from the December 2017 actuarial valuation; and
- that the assumptions supporting the December 2017 actuarial valuation are reasonable and are supported by independent benchmarking against other pension schemes.

3.21 In addition, to the extent business activities are included in the wider requirements of the plan then evidence should be provided showing:

- pension deficit costs, as they relate to past service, will all be identified as core costs, whereas ongoing pension costs, because they relate to future service, may be shown as both core and wider costs; and
- the allocation of ongoing costs pension costs has been made on a reasonable basis.

## Consultation questions

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4. Is the broad approach to the draft business plan guidance on costs reasonable and is there additional third party assurance that NERL could reasonably provide to help demonstrate its forecasts of costs are efficient?
5. Should the business plan set out information to facilitate the ex-post efficiency reviews of RP2 capex (which could include the disallowance of inefficient expenditure from NERL's RAB) or would these reviews be best carried out by a separate process?
6. Is the above draft business plan guidance on transparency of NERL's capital programmes and projects fit for purpose or could it be further improved?

7. Is there stakeholder support for the continuation of the FFF? If so, do the current governance arrangements remain appropriate for RP3? Should we give further business plan guidance to NERL on the FFF arrangements?
8. Should we provide further business plan guidance on expenditure governance arrangements and/or incentives?
9. Is the draft guidance set out above on pensions reasonable and can it be improved?



## Chapter 4

# Financeability

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- 4.1 Efficient prices require the efficient financing of capex. This chapter sets out draft business plan guidance to NERL on key aspects of financeability, including the cost of capital and the profiling of regulatory depreciation.

## Cost of capital

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- 4.2 The cost of capital should remunerate providers of capital for their investment and be calibrated according to the risk that the business faces. NERL should assume a cost of capital no more than the efficient level necessary to compensate NERL for the business and regulatory risks it faces. Its business plan should identify a balanced set of proposals for incentives that both promote efficiency but also do not unduly increase risks and financing costs. The objective should be a set of arrangements that lead to the lowest overall costs for consumers. In formulating its business plan and proposals for an efficient cost of capital NERL will need to consider and transparently set out its assumptions and supporting evidence in respect of:
- regulatory precedent published since the RP2 decision;
  - market evidence on cost of capital parameters;
  - its business risks (that should include its proposals for the treatment of pension deficit costs and the incentive framework); and
  - risks arising from external factors (e.g. uncertainty arising from Brexit).
- 4.3 In relation to regulatory precedent we intend to publish our early and preliminary views on the cost of capital for the next HAL price control review in December 2017. This document will include information on the market wide components of the cost of capital (e.g the risk free rate).
- 4.4 NERL should also be clear about any differential risks associated with the core and wider sections of its business plan and its proposals for the treatment of any such differences.

## Regulatory asset base and regulatory depreciation

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- 4.5 The level of depreciation is expected to fall during RP3 as the assets at privatisation are fully depreciated. The impact will be a one-off fall in depreciation in 2021 that may impact on revenues and cash. NERL should set out how it considers these matters should be best addressed in its business plan.
- 4.6 Lower cash flows may mean that NERL has a reduced ability to fund capex out of its operating cash flows and/or a reduced ability to fund dividend payments. These are normal features of a RAB based approach to determining price controls. Nonetheless, the lower level of regulatory depreciation may create challenges for efficient financing and in these circumstances NERL should make proposals that will allow it to retain access to financing on efficient terms.
- 4.7 Consistent with the approach we have adopted to the regulation of HAL we will be open minded about more flexible approaches to the profiling of regulatory depreciation in the future, provided that they deliver an appropriate balance between affordability and financeability.
- 4.8 If NERL considers that a different approach to regulatory depreciation is necessary to provide for efficient financing it should clearly set out its reasoning and any changes to assumptions on asset lives and/or depreciation profiles. The business plan should demonstrate the impact of the different options on user charges and on NERL's financeability both during RP3 and in subsequent periods. Any changes to approach to address short-term financeability concerns should also be consistent with efficient financing in the medium or longer term.

## Assessing financeability

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- 4.9 A key indicator of financeability are the metrics used by credit rating agencies ratings to assess credit quality. For companies subject to RAB based regulation these metrics typically focus on interest coverage and debt to RAB ratios. Possible financeability challenges for NERL include its profile of regulatory depreciation discussed above and its pension deficit discussed in Chapter 3. NERL will also need to consider whether its proposals for incentives and size of its forecast capital programmes have implications for financeability.
- 4.10 In demonstrating that its business plan is financeable NERL should consider and present evidence on the:
- target credit rating that has informed its business plan;
  - metrics and indicators associated with this credit rating; and
  - scenarios that have been tested and the results of this testing.

- 4.11 When conducting financeability analysis, NERL should present evidence on:
- what corresponds to a successful financeability test. For example, does a temporary failure to meet a particular metric or threshold require action or must there be evidence of more persistent problems;
  - if there is a need for action, then what are the appropriate actions that are also consistent with affordability, including:
    - the provision of new equity; or
    - increasing revenues in an NPV-neutral way (e.g. changing depreciation policy).
- 4.12 NERL will need to demonstrate that its business plan is financeable on the basis of its core activities and separately on the basis of core and wider activities.

## Consultation questions

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10. Is the draft business plan guidance on the cost of capital, regulatory depreciation and financeability appropriate

## Chapter 5

## Customer consultation

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- 5.1 This Chapter sets out for consultation our expectations in respect of NERL's approach to customer consultation for the RP3 regulatory review. It addresses both our expectations relating to activities that fall under the formal customer consultation mandate, in addition to the wider stakeholder views that should be addressed by NERL in the development of its business plan. We intend to publish the mandate alongside our final business plan guidance in January 2018, informed by stakeholder responses to this consultation.
- 5.2 In previous regulatory reviews NERL's customer consultation has focussed on airspace users. With the expectation that NERL will have a significant role in the development of South East airspace in RP3 we consider that airports should also be key consultees. Therefore, where we refer to customers below, we mean both airspace users and airports.
- 5.3 Some of the wider policy issues, particularly resilience and noise, have direct impacts on final consumers (i.e. passengers), and overflowed communities. We expect NERL to be innovative in the way in which it engages to understand the views of these important stakeholders and that the business plan sets out its approach to taking account of all customer, consumer and community views.

### **Broad approach to consultation**

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- 5.4 To produce a high quality business plan we expect that NERL will need to take into account customers views and requirements in formulating its IBP. It will then need to engage with its customers to refine and calibrate the plan and take their views into account in formulating its RBP. This should help ensure NERL's future plans are aligned with airspace users' and airports' interests.
- 5.5 To support these processes we will publish a Customer Consultation mandate to encourage NERL, airspace users and airports to participate in a structured and meaningful programme of engagement and discussion, following publication of NERL's IBP in March 2018.
- 5.6 A successful customer consultation requires meaningful engagement to take place, which in turn requires from NERL transparency, quality and timely information, and a responsive approach to customers' queries. It also requires those customers (airspace users and airports) to ensure they participate constructively and that all parties engage in good faith.

- 5.7 We expect NERL to engage constructively to identify and understand its customers' priorities for RP3 and ensure these are taken into account in formulating its RBP. Where it cannot meet these priorities and demands, we expect NERL to provide a cogent, persuasive and timely explanation.

## The approach in RP2

- 5.8 In developing the customer consultation mandate for RP3 we hope to improve on the consultation process used for RP2. We have already identified above the advantages of ensuring that airports have the opportunity to participate in the process for RP3. Key aspects of the RP2 process are summarised below.
- 5.9 NERL's processes for customer consultation in RP2 included a Customer Consultation Working Group (CCWG) which included airlines and involved a series of focused plenary meetings and supplemented by further workshops on particular subjects. The CAA asked the parties to agree on an independent chair or co-chairs of the process, respect process rules, and complete the process with a joint report to the CAA on the areas of agreement and disagreement between the parties.
- 5.10 The issues covered included:
- the key priorities of airspace users for the RP2 period and beyond for UK en route services;
  - NERL's proposed plans for meeting airspace users' needs in RP2, in terms of the Key Performance Areas under the performance regulation: safety, environment, capacity and cost efficiency;
  - key components of NERL's business plan including traffic projections, its capital plan, opex and financing costs;
  - the steps that NERL was taking to improve its cost efficiency in RP2 and beyond;
  - NERL's programmes (including costs and benefits) required to deliver the FAS;
  - NERL's ambitions and plans for delivering improved outcomes for users through its relationship with the IAA ANSP and the UK-IE FAB;
  - the use of incentive mechanisms to incentivise NERL's performance;
  - the priorities of airspace users in relation to certain trade-offs relating to strategic choices NERL could make regarding cost and service quality; and
  - airspace users' requirements for Oceanic services for the reference period.
- 5.11 Further details on the RP2 Customer Consultation Mandate are contained in [CAP1019](#).

## **Wider approach – passengers and affected communities**

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- 5.12 Recognising the impact of NERL’s activities on passengers (in particular resilience) and overflown communities (in particular noise) it should consider carefully how best to ensure their views are taken into account in its IBP and RBP. NERL may need to develop innovative approaches to take reasonable account of the views of these diverse groups. At the very least it should consider existing research on their preferences and views and consider how best to consult bodies representing passengers and/or communities.
- 5.13 We expect the IBP to set out the processes by which the views of these stakeholders will be taken into account. We also expect NERL to continue to consider these broader views throughout the process – not just in development of the IBP, but also during discussions under the Customer Consultation mandate and in the production of the RBP.

## **Role of the CAA**

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- 5.14 We will carefully consider any responses to this consultation in finalising the customer consultation mandate for RP3. Once NERL has issued its IBP we will make sure we are properly informed of the progress and the substance of discussions between NERL and its customers. Any party (including those not involved directly in the CCWG exercise) will be able raise any concerns directly with the CAA about the conduct or progress of the customer consultation process at any time.

## **CAA consultancy studies**

- 5.15 The CAA will also conduct its own research on and scrutiny of NERL’s RP3 business plan. In response to feedback on the RP2 process and CAP 1511, we are currently planning to commission a number of studies to help inform the customer consultation process.
- 5.16 Appendix D sets out our current thinking on proposed consultancy studies in terms of objectives, outline scope and deliverables. It is our intention to make these studies available, as soon as practicable, after publication of NERL’s IBP. Some of these may need to be updated following the customer consultation process and submission of NERL’s RBP, or come later in the process.

## Consultation questions

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11. How should we best include airports in the scope of the Customer Consultation mandate?
12. What steps should NERL take to reflect the views of wider stakeholders, such as passengers and overflowed communities, in the development of its business plans?
13. Should the customer consultation process follow the same broad approach as RP2, with a requirement for a structured engagement programme, customer consultation working group and an independent/joint chair?
14. What topics should the customer consultation programme address and what improvements can be made compared to the process for RP2?
15. Are there alternative model(s) of customer consultation that might be followed for RP3 – bearing in mind the constraints created by needing to align the timetable for customer consultation with the SES Performance Scheme and associated milestones.
16. What views do stakeholders have on the proposed CAA consultancy activities as discussed above and set out in Appendix D – in particular the nature of the proposed studies, their objectives, scope and deliverables?

## APPENDIX A

# Our duties

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The Transport Act 2000 gives the CAA a primary duty to exercise its functions so as to maintain a high standard of safety in the provision of air traffic services.

In exercising its functions the CAA must do so in a manner it thinks best calculated:

- to further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them;
- to promote efficiency and economy on the part of licence holders;
- to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences;
- to take account of any international obligations of the United Kingdom notified to the CAA by the Secretary of State (whatever the time or purpose of the notification); and
- to take account of any guidance on environmental objectives given to the CAA by the Secretary of State after the coming into force of this section.

Commission Implementing Regulation (EU) No 390/2013 of 3 May 2013 laying down a performance scheme for air navigation services and network functions gives the CAA, as national supervisory authority for the UK, responsibility for:

- drawing up of the Performance Plans; and
- performance oversight and the monitoring of Performance Plans and targets.



**APPENDIX B****Consultation questions**

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1. Do stakeholders consider that a two track approach to NERL's business plan is reasonable?
2. Do stakeholders have views on the allocation of activities and outputs between the core and wider categories for NERL's business plan?
3. Are there any further views from stakeholders on extending the scope of the incentives on NERL to put greater emphasis on resilience and noise?
4. Is the broad approach to the draft business plan guidance on costs reasonable and is there additional third party assurance that NERL could reasonably provide to help demonstrate its forecasts of costs are efficient?
5. Should the business plan set out information to facilitate the ex-post efficiency reviews of RP2 capex (which could include the disallowance of inefficient expenditure from NERL's RAB) or would these reviews be best carried out by a separate process?
6. Is the above draft business plan guidance on transparency of NERL's capital programmes and projects fit for purpose or could it be further improved?
7. Is there stakeholder support for the continuation of the FFF? If so, do the current governance arrangements remain appropriate for RP3? Should we give further business plan guidance to NERL on the FFF arrangements?
8. Should we provide further business plan guidance on expenditure governance arrangements and/or incentives?
9. Is the draft guidance set out above on pensions reasonable and can it be improved?
10. Is the draft business plan guidance on the cost of capital, regulatory depreciation and financeability appropriate?
11. How should we best include airports in the scope of the Customer Consultation mandate?
12. What steps should NERL take to reflect the views of wider stakeholders, such as passengers and overflowed communities, in the development of its business plan?

13. Should the customer consultation process follow the same broad approach as RP2, with a requirement for a structured engagement programme, customer consultation working group and an independent/joint chair?
14. What topics should the customer consultation programme address and what improvements can be made compared to the process for RP2?
15. Are there alternative model(s) of customer consultation that might be followed for RP3 – bearing in mind the constraints created by needing to align the timetable for customer consultation with the SES Performance Scheme and associated milestones.
16. What views do stakeholders have on the proposed CAA consultancy activities as discussed above and set out in Appendix D – in particular the nature of the proposed studies, their objectives, scope and deliverables?

## APPENDIX C

# Summary of responses to CAP 1511

The CAA received eight responses from stakeholders to CAP 1511. This section summarises the responses given to this consultation.

## Approach and strategic objectives of RP3

Respondent	Response
<b>NERL</b>	<p>NERL notes that the CAA did not include safety as a strategic outcome, given that NERL's pursuit of economic and service quality outcomes will always be in the context of maintaining safety. NERL feels that given the importance of safety, especially in light of the rise in Unmanned Traffic or "drones," safety must actively and continuously be considered above any other outcomes. In total, NERL suggests seven strategic outcomes that should be considered for RP3:</p> <ul style="list-style-type: none"> <li>▪ A safe service.</li> <li>▪ Service quality and resilience that reflects customer requirements and licence compliance.</li> <li>▪ Modernising our airspace to address capacity constraints and completing the renewal of our ATM systems infrastructure.</li> <li>▪ Efficient prices.</li> <li>▪ A coherent plan that is flexible enough to respond to changing industry conditions.</li> <li>▪ The right incentives.</li> <li>▪ Effective accountability mechanisms.</li> </ul> <p>Note that bullets 2, 4 and 7 were included in CAP 1511 as outcomes already being considered.</p>
<b>Prospect</b>	<p>Prospect notes that the development and regulation of commercial drones should be factored into RP3, which they state could have an impact on airspace design and will certainly have an impact on complexity.</p> <p>Prospect is also very concerned about safety not being included as a meaningful discussion point. While they note that the CAA discusses it in relation to the Transport Act, they note that it is ignored after this. They believe that taking safety "as a given" risks complacency arising.</p>

Respondent	Response
<b>Airlines</b>	Both British Airways and Virgin Atlantic Airways are supportive of the strategic outcomes prioritised by the CAA in the discussion document. Both note that the focus on accountability, cost and service outcomes is aligned with how they manage suppliers.
<b>London Biggin Hill Airport (LBHA)</b>	LBHA believes there is no effective competition available for the Thames Radar, which LBHA is currently obliged to use. This is not an issue if all users are treated in an equitable manner, but at present LBHA is effectively subsidising other users through the commercial rates charged by NERL via NATS Services Ltd (NSL). For example, it calculates that it was charged £129k in 2016 for relatively similar services that London City Airport is being provided, yet based on their calculations London City Airport is charged £32k. As such, LBHA believes that it should be included as one of the airports covered as part of the regulated charges.

## Outcomes and outputs for RP3

Respondent	Response
<b>Resilience and quality of service</b>	
<b>NERL</b>	<p>NERL note that CAA's views on service quality expressed in CAP1551 highlight a potential mismatch between NERL and CAA's understanding. NERL argue that its Performance Plan determines the level of service that it can be held accountable for, and therefore that there needs to be more clarity about how any minimum licence conditions relate to the RP3 Performance Plan.</p> <p>They are broadly supportive of a focus on resilience but argue that the CAA must allow for relevant operating costs and that the CAA will need to consider:</p> <ul style="list-style-type: none"> <li>▪ Separate treatment of resilience for the purposes of licence requirements and resilience for service quality.</li> <li>▪ Balancing resilience requirements against efficient prices with consideration of short-term versus long-term trade-offs.</li> </ul> <p>Recognition in NERL's cost of capital of the imposition of extra requirements on NERL in terms of resilience implies extra risk for our shareholders.</p>
<b>Airlines</b>	<p>Both British Airways and Virgin Atlantic Airways support the CAA's aim to continuously improve NERL's service quality and that resilience should be explicitly prioritised within that. They support a review of how best to measure NERL capacity and delay performance and see a link to the CAA's proposed enforcement metrics in CAP 1512.</p> <p>BA were particularly supportive of proposals that where there are capacity constraints that NERL should 'act in the interests of the air traffic management network as a</p>

Respondent	Response
	whole' believing that this would reflect the importance of the London airport system.
<b>Prospect ATCO Branch</b>	<p>Supportive of CAA's broad strategic approach. However, they note that there may be a link between outcome 2 (efficient prices) and improved service quality, and that the latter should not be sacrificed for reduced prices.</p> <p>They also suggest that the CAA should take a flexible approach to targets – for example resetting NERL targets should unforeseen circumstances occur.</p>
<b>Gatwick Airport</b>	<p>GAL expect a continued focus on delay/capacity performance in RP3. They also suggest the need for improved transparency on NERL performance to hold it better accountable.</p> <p>Finally, they also suggest an incentive regime that balances near term service quality and longer term airspace and operational changes.</p>
<b>Noise and environment</b>	
<b>NERL</b>	<p>The company addresses flight efficiency and noise separately. For flight efficiency, it states that it will continue to provide improvements to flight profiles in areas it can control, with airlines regarding it as extremely important for sustainable growth, financial viability and in support of their commitment to carbon neutral growth through IATA. However the current 3Di metric will need to be recast to take account of: 1) challenges to the delivery of change to low level airspace around airports driven primarily by local resident concerns about noise impacts or even the concept of change 2) the willingness of airspace users to engage with NERL to understand their role in delivering airspace efficiency through improvements to flight planning and operations 3) the advent of Unmanned Aircraft System Traffic Management (UTM) that will further constrain low level airspace.</p> <p>For noise, it states that this has the potential to be a significant impediment to NERL's objective to deliver airspace modernisation during RP3. However, in delivering the RP3 investment important considerations in managing or mitigating noise impacts include: 1) working with industry, regulators and community groups to ensure we have metrics and language to appropriately describe changes to airspace and procedures and measure the impacts of those changes; 2) engaging with residents around airports to understand the nature of solutions to noise issues, recognising that local solutions may be needed to local concerns; 3) ensuring consultation arrangements are fit for purpose and use techniques that give all stakeholders the ability to design jointly agreed solution; 4) continuing to explore innovative approaches to noise management (e.g. respite) that enable airspace change whilst managing the impact of noise.</p> <p>The company also suggests that targets for capacity and the environment need to reflect trade-offs between: 1) Cost v benefit 2) Capacity v noise - asking the CAA to</p>

Respondent	Response
	lead a cross-industry approach 3) Noise v emissions
<b>Airlines</b>	BA and Virgin Atlantic suggest that changes to noise policy will need to take account of wider policy issues of airspace redesign and runway expansion, and that mitigating noise impacts needs to be considered alongside delivery of new capacity and future operating costs for airspace users.
<b>Prospect ATCO Branch</b>	Prospect supports in theory NERL being allowed to take account of other factors, including noise in the pursuit of more efficient flight. However, it notes that NERL is not the only body responsible for decisions on flight efficiency, so a broader understanding of how external influences would affect NERL's ability to achieve success in this field would need to be understood.
<b>Gatwick Airport</b>	The company considers that NERL is not measured or held to account for whether and how it considers other environmental factors, such as noise. It believes that NERL's environmental incentives should be broadened to include local noise as well as carbon emissions, and notes that the existing flight efficiency incentive may militate against noise solutions which reduce horizontal flight efficiency.
<b>Heathrow resident</b>	The resident strongly supports NERL's outcomes including the impact on noise from changes to operational procedures, and states that recent changes have highlighted a lack of proper consideration of impact, communication and transparency. The resident continues that the situation should be remedied, possibly by including noise in the 3Di metric, and states that, when NERL redesigns airspace through LAMP2, the interests of communities on the ground should be taken into account.

## Cost assessment

Respondent	Response
<b>Capex</b>	
<b>NERL</b>	Accountability mechanisms should be flexible and responsive, as well as providing scrutiny and governance of any decisions, taking into account where accountability falls solely on NERL or other parties.
<b>Airlines</b>	A key priority for 2020-24 is the delivery of LAMP2. This has been delayed since RP2 and the effects of congestion and delay are being felt. British Airways is of the view that LAMP2 should remain separate from the third runway.  The airlines welcome more regulatory scrutiny and consultation to allow them to make 'meaningful input' through the SIP process.
<b>Prospect ATCO Branch</b>	Accountability mechanisms should be output-based and designed to not distort activities/incentivise wrong behaviours. It is important that price is not prioritised at the

Respondent	Response
	expense of quality.
<b>Gatwick Airport</b>	<p>NERL's stakeholder engagement should also include airports, both in the Business Plan and during the determination. GAL requests additional transparency on how NERL identifies, scopes, prioritises and funds improvement projects.</p> <p>Effective accountability mechanisms are welcomed in respect of both direct customers and other stakeholders whose performance can be affected by NERL's service, planning and investments. As with Prospect, price reductions should not come at the expense of a deterioration in quality.</p> <p>There should also be clarity around roles and responsibilities in developing an airspace masterplan.</p>
<b>Efficiency</b>	
<b>NERL</b>	<p>In consideration of efficient prices, NERL states that it will be important to ensure that efficient levels of operating and capital costs need to be allowed for when delivering these, which is supported by benchmarking that robustly makes like-for-like comparisons. NERL also state that capex and opex analysis as a whole should be considered, with the potential for flexibility in the different types of spend, as this will enable customer benefits to be delivered in the most cost effective way. When conducting efficiency benchmarking, NERL notes that the CAA should consider the following:</p> <ul style="list-style-type: none"> <li>▪ Other ANSPs have more favourable pension arrangements and/or support from their governments.</li> <li>▪ NERL's prices do not reflect the higher service expectations, intolerance to technical failures and additional constraints that other ANSPs do not have.</li> <li>▪ ACE benchmarking is a "truer" representation of NERL's costs than unit rate league tables and should be used for comparisons instead. ACE reports indicate NERL's performance is consistent with the "big 5" ANSPs.</li> <li>▪ Having said the above, even ACE benchmarking does not take account of the complexity of NERL's traffic, especially in the London Terminal Manoeuvring Area, which limits NERL's ability to reduce its prices to be comparable to cheaper states with less complex traffic.</li> </ul> <p>NERL also mentions that introducing some form of Rolling Incentive Mechanism could enable greater efficiencies to be passed onto customers at a later date.</p>
<b>Airlines</b>	BA and Virgin Atlantic's main concern is that the CAA ensure that NERL delivers opex and capex efficiently with the aim of controlling and potentially reducing prices.
<b>Prospect</b>	In the case of cost efficiency, Prospect notes that the CAA must consider the

Respondent	Response
	<p>interdependencies between other areas such as cost of service provision.</p> <p>Prospect notes that judgements about NERL's unit cost rate must be made with caution, and would have liked to have seen a caveat around the complexity of the airspace and the services provided in paragraph 2.14 of the discussion paper. Prospect does not believe there is much more "give" in terms of cost reduction from an operational perspective, certainly if quality of service delivery and delay are to be improved and mitigated respectively. Therefore, the CAA must fully explore the consequences of continued pressure on outcome 2 (efficient prices) and the effect this might have on outcome 3 (service quality and resilience). Costs should be examined on a "felt fair"/value for money basis, not a line-by-line audit which questions resource decisions made quite legitimately by the business.</p> <p>Where costs are subject to analysis, sensible benchmarks should be used. Previous benchmarking staff costs was poor in RP2 with the Income Data Services (IDS) report being of low quality. Benchmarking should not be done internationally, given different taxation and pension arrangements, not to mention the impact of exchange rates. The labour market for ATCOs has matured since RP2 and the active and tight market for tower controllers has seen pay rates increase in the last couple of years. As a general comment, Prospect note that ANSPs are struggling to recruit the numbers and quality of trainees they require.</p> <p>Prospect believe a total economic value approach should be adopted, where the entire system and its value is viewed rather than simply the unit cost per flight. This approach will benefit the airspace users and the travelling public more and represent the true value of NERL's service delivery.</p>
<b>Pensions</b>	
<b>NERL</b>	<p>The company agrees with the CAA that at privatisation its DB Scheme had a number of enhanced legal protections which constrained management's scope for fundamental change to its costs and risks. Despite this, it had taken action to mitigate costs, by closing the Scheme to new members, capping pensionable pay increases at CPI, indexing future service at CPI, and de-risking the investment strategy. The (partial) pass-through of pension costs plays a significant part in reducing the cost of pensions, as Trustees take these arrangements fully into account when assessing the strength of NERL's employer covenant. Without them, Trustees would factor in a higher risk assessment leading higher pension contributions and higher prices. Maintaining the symmetry of (partial) pass-through is important, both for the strength of the employer covenant and the benefit of customers when financial markets improve. NERL will continue to act in a manner consistent with a commercially minded company in seeking to mitigate the costs and risks of the Scheme, within the legal constraints that exist.</p>



Respondent	Response
<b>Airlines</b>	British Airways and Virgin Atlantic Airways support the CAA's use of independent benchmarking to inform policy, and note that pensions obligations are an issue which impacts NERL, BA and other companies.
<b>Prospect ATCO Branch</b>	Prospect is concerned over the tone of the (CAA's) paper where it discusses pension financeability - the DB Scheme. Prospect will resolutely defend any perceived attack on the Scheme, which is a key element of employees' terms and conditions. Prospect seeks an early assurance that there will be no change in the CAA's attitude to pension costs pass-through for RP3. Prospect states that it continues to act responsibly in protecting a key covenant from privatisation, with staff engaging twice to alter the scheme to support NATS' viability, in the context of the legal protections in place. Risks are also being mitigated through dwindling membership reducing liabilities and increasing actuarial certainty.
<b>CAAPS Trustee</b>	The Trustee of the CAAPS <sup>11</sup> notes that, unlike most regulated industries, the size of NATS section of the Scheme is many times the RAB, with the result that the strength of the sponsor covenant supporting the Section is derived predominantly from NERL's pricing framework, rather than the assets of NERL. If the Trustee were no longer confident in the long-term stability of the framework, then it would be required to take a more cautious approach to investment and funding, leading to substantial increases in expected ultimate pension costs and short-term cash demands. Therefore, there is a clear economic benefit to airspace users in the continuation of a stable and predictable regulatory pricing framework with respect to pensions over the long term. To support this framework, the Trustee fully appreciates why it is appropriate for the CAA to test the good stewardship of the Section and require NERL to behave in a manner consistent with a commercially minded company.

## Financeability

Respondent	Response
<b>NERL</b>	With regard to financeability, NERL recommends that the CAA conducts a full financeability assessment of NERL's business, considering a whole range of plausible business scenarios for revenue and costs. This should also consider incentive arrangements, and the impact of balancing financial rewards for outperformance with the potential risks to financial sustainability of underperformance. If the overall

<sup>11</sup> CAAPS is the Civil Aviation Authority Pension Scheme, and was set up in 1973 for the then newly-established Civil Aviation Authority. After the Government separated the business of air traffic control to NATS, in the run-up to the establishment of its public-private partnership in 2001, the Scheme was continued in two sections - the CAA and NATS sections. The sections are run independently, with no financial links between the two. The response from CAAPS Trustee above refers to the NATS section only.

Respondent	Response
	<p>regulatory package is a threat to NERL's ability to finance itself efficiently, it will be necessary for the CAA to reconsider NERL's RP3 allowance and/or measures to mitigate risks.</p> <p>NERL specifically mentions that "the right incentives" should be one of the outcomes of the RP3 process, which will be those that focus the business on the best outcomes for customers, and includes the right cost of capital and strong incentives to invest and to innovate. Particular considerations that it feels will be important include adequate return allowances in the regulatory framework and it should consider the impact of incentives on shareholder return given its small RAB relative to other regulated entities. NERL also believe that risks should remain symmetric in the interests of efficient pricing, and the asymmetric risks are likely to have an adverse effect on the cost of capital.</p> <p>NERL believes that it is particularly susceptible to risks associated with Brexit, given that it has performance targets set at an EU-wide level set by the EC. In particular, the UK could be subject to SES regulation without having a "voice" at the Single Sky Committee, which in turn could create financeability and other risks which the CAA will need to take account of in its determinations.</p>
<b>Airlines</b>	<p>The airlines note that cost of capital will be a key regulatory debate, and they expect the development of the Performance Plan to take account of prevailing market conditions and the impact of other changes such as the extension of the NERL notice period to 15 years, which would have a beneficial impact in this area.</p>

## Customer consultation

Respondent	Response
<b>NERL</b>	<p>NERL believed the CAA should provide a set of regulatory assumptions in June 2017 about pension pass-through and inflation treatment to enable NERL to begin scenario planning.</p> <p>NERL set out that the plan would need to balance key performance areas and have flexibility to deal with short, medium and long-term changes to the business environment. As such, the need for coherence in its plan pointed to a need to:</p> <ul style="list-style-type: none"> <li>▪ focus on safety and service quality, rather than price;</li> <li>▪ avoid optimising performance targets in isolation from one another;</li> <li>▪ set targets with regard to outputs rather than inputs;</li> <li>▪ include a sensible level of contingency in opex allowances;</li> <li>▪ have sufficient flexibility to vary capital investment subject to customer</li> </ul>

Respondent	Response
	<p>consultation and regulatory support;</p> <ul style="list-style-type: none"> <li>▪ analyse costs in a way that considers potential flexibility in terms of opex- and capex-based delivery;</li> <li>▪ set performance targets that recognise the challenges faced by NERL; and</li> <li>▪ set targets that adjust in line with changing traffic conditions.</li> </ul>
<b>Airlines</b>	<p>British Airways suggested that consultation work during the programme should be aligned with the proposed strategic outcomes.</p> <p>British Airways and Virgin Atlantic Airways welcomed the CAA's proposals on investment planning and delivery and the recognition that a "greater level of regulatory scrutiny and meaningful consultation" is expected by all stakeholders, and considered they should be able to make "meaningful inputs" to NERL investment decisions and the consultation through the interim SIP process and the recent "deep-dives" held by NERL should support this.</p>
<b>Prospect</b>	<p>Prospect felt staff were consulted at a late stage in RP2 and it is possible earlier input may have been provided a higher degree of rigour in some of the decisions.</p> <p>Therefore, they propose that a modification is made to the NERL licence that places requirements on NERL to consult with its staff, which could be consistent with existing European FAB legislation. It notes there is already an established relationship between it and NERL, but consider that acknowledgement from the regulator of the value of the expertise the union and its members bring to the planning, development and execution of the reference periods is vital to its success.</p>
<b>Gatwick Airport</b>	<p>GAL believed the consultation process should include airports as well as airspace users, given the recent experience with delays in the London Terminal Manoeuvring Area (TMA). This should inform NERL's consultation on its IBP and its wider investment planning process.</p>

## EU context and timetable

Respondent	Response
<b>EU context</b>	
<b>Airlines</b>	<p>The airlines note that the status of existing and future funding from Europe is unclear at this time and they note that until there is more clarity, the impact on NERL deliverables and potentially prices is unknown.</p> <p>The airlines also acknowledge that the EC's work on the SES performance framework incentives should guide or inform service quality incentives. The airlines expect that the current regulatory framework should support incentives to innovate and realise</p>

Respondent	Response
	cost savings within the regulatory period and in the long-term for all stakeholders.
<b>Gatwick Airport</b>	GAL notes that it is imperative the regulatory framework achieves consistency between the UK's strategic priorities and the revised EU regulations. NERL investment in long-term infrastructure should not be inhibited by the Commission revisions to the charging regulation for RP3, which aim to drive reductions in the en route charge.
<b>Timetable</b>	
<b>NERL</b>	NERL believed the timetable was challenging and its achievability would rely on commitment from different stakeholders to the timetable (NERL, airlines and CAA) as well as the CAA providing NERL with a set of regulatory assumptions in June 2017 about pension pass-through and inflation treatment to enable NERL to begin scenario planning.
<b>Airlines</b>	BA and Virgin Atlantic supported the proposed timetable and the alignment with the EC's key milestones for the development of the RP3 Performance Plan. BA suggested that consultation work during the programme should be aligned with the proposed strategic outcomes.
<b>Prospect</b> <b>ATCO Branch</b>	Prospect was content with the timetable.

## APPENDIX D

# Consultancy studies

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In support of customer consultation and our review of the NERL business plan and development of the UK Performance Plan for RP3, we intend to commission consultancy studies based on our approach at RP2 that could include:

- Cost allocation
- A non-staff opex review of NERL
- A staff opex review of NERL
- A capex review of NERL
- Cost of capital estimation for NERL
- An analysis of pensions costs

Draft specifications for these reports are set out below. We welcome comments on the range, scope, content and timing of these studies.

## Cost allocation

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### Objective

To commission advice on whether the CAA can rely on the allocations and apportionments that NATS Holdings Ltd makes between:

- its licensed business and the unlicensed business;
- the different segments of its licensed business; and
- the allocations that it makes to operating and capital costs,

for the purpose of regulating charges and setting cost effectiveness targets for various segments of the NERL business.

### Scope

The licensed and unlicensed businesses are operated as separate subsidiaries of NATS Holdings Ltd. There are cross charges of costs between the licensed and unlicensed companies and from the holding company. These charges included:

- Oceanic Price Control: Which is a relatively small segment of the business which is not covered by EU regulations and for which there is a separate simple RPI-X price condition in the NERL Licence; and
- UK Air Traffic Services, which is further broken down into:
  - Eurocontrol business: This is the major part of the licensed business. It is subject to the SES performance and charging regulations and given effect through a charging condition in the NERL licence;
  - North Sea Helicopters: a small specific service subject to the licence with no charge control (largely provided from airports with NSL resources);
  - London Approach: a service provided from the Area Control Centre at Swanwick alongside en route services.
- Other permitted business consists primarily of a contract to provide infrastructure costs to the Ministry of Defence for which there are common costs issues.

There are also services:

- provided by NERL for the rest of the Group;
- provided in conjunction with the Irish as part of a FAB; and
- in any other connected business up to 4.5% of turnover.

The unlicensed business consists of the activities of NSL. Its core business is the provision of ATC services at 15 UK airports plus Gibraltar under contract to the airport operator. While these airports are not subject to formal regulation under domestic legislation those with more than 70,000 (instrument flight rule) movements will be subject in aggregate to a five-year cost effectiveness target under EU legislation. NSL provides various other services in the UK and abroad.

NSL also has a joint venture with Spanish infrastructure Ferrovial, which is contracted to provide air traffic control tower services at ten airports in Spain.

## **Deliverables**

The advisor should state whether the approach to cost allocation is fair and appropriate. The output will be a publishable quality report. The report should summarise the approach to cost allocation, allocation of capex, opex and revenues, intercompany agreements and analysis of the approach.

The advisor may be expected to present their findings to the CAA.

## Non-staff opex review

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### Objective

To commission advice on suitable projections of non-staff operating expenditure required to deliver future services. Cost efficiency is one of the key performance indicators (KPIs) under the SES Performance Scheme and as such the CAA wishes to ensure that projections are efficient.

### Scope

Non-staff opex should be considered at an aggregate level and in some cases a detailed level to determine if the projections are challenging and achievable. There are five main areas of opex to consider:

- facilities management (mainly rent, rates, utilities, maintenance);
- non-operating IT (mainly support contracts);
- asset management (mainly Post Delivery Services and connectivity);
- business support (temporary staffing, travel costs and specialist back-office support); and
- general items (mainly software builds, CAA fees, business development).

The review should consider trends in opex relative to previous years' plans and where possible, conduct benchmarking analysis against suitable comparators.

Where there are changes in price, consideration of whether they are justified and robust.

While the review will focus upon opex, interdependencies with capex need to be considered.

### Deliverables

The main deliverable for this project will be a publishable quality report, with the expectation that any underlying data analysis (e.g. spreadsheets or relevant econometric commands) should also be provided to the CAA.

The advisor may be expected to present their findings to the CAA.

## Staff opex review

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### Objective

To advise the CAA on the level of employment costs that NERL is able to achieve, and the scope to reduce these costs through efficiency savings from 2020-24 with reference to the NERL IBP.

## Scope

For the purpose of regulating charges and setting cost efficiency targets for NERL, to consider whether the proposed staff costs are challenging and achievable in the context of the service levels proposed.

The scope of the study includes:

- the en route air traffic services funded from Eurocontrol charges in UK airspace;
- the London Approach specifically the radar approach services for major airports in the London Area where the air traffic management service is provided from Swanwick. (The scope excludes capex supporting the visual control services provided by NSL from the relevant airport towers);
- the Oceanic services for a portion of the North Atlantic provided from Prestwick; and
- intercompany trading between NERL and NSL, NERL licensed helicopter services in the North Sea), Ministry of Defence contract (FMARS) and other revenue (including SES ATM Research (SESAR) Joint-Undertaking funding).

## Deliverables

The main deliverable for this project will be a publishable quality report, with the expectation that any underlying data analysis (e.g. spreadsheets or relevant econometric commands) should also be provided to the CAA.

The advisor may be expected to present their findings to the CAA.

## Capex review

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### Objective

Form a view and provide advice to the CAA on NERL's current and prospective ability to deliver investment projects efficiently and effectively, taking account of NERL's performance.

### Scope

Issues to be considered on a forward-looking basis include:

- the level of consultation around the initial capex programme;
- whether the projects proposed are measurable in relation to the associated capex;
- the governance process around capex during the RP3 period; and
- how NERL has demonstrated value for money.

There will also be an ex-post efficiency review of capex incurred during RP2, looking at:



- whether the total costs compare to the planned cost of delivery;
- whether the planned benefits have been delivered and to the timetable assumed;
- the balance of internal and external suppliers, and the testing of relative costs;
- the reasons for changes in cost (scope versus cost overruns);
- consultation with users for any changes in the programme; and
- the level of risk and contingency included and whether this was appropriate.

## Deliverables

The main deliverable is a report that will be split into two parts. The first part of the report will focus on a forward-looking investigation of whether the proposed approach for RP3 is suitable. The second part of the report will involve a historic review of the efficiency of capex during RP2 for NERL.

The advisor may be expected to present their findings to the CAA.

## Cost of capital review for NERL

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### Objective

To assess what a suitable cost of capital is for NERL in RP3, focusing on company specific parameters, namely:

- the allowed cost of debt; and
- the equity beta.

The return should be sufficient for NERL to not unduly struggle to finance their activities, while the CAA wants the return to be commensurate with the level of risk faced.

### Scope

The analysis on these parameters should take into account relevant market evidence, regulatory precedent and be relative to suitable comparators.

The advisor will be required to arrive at a preliminary view on these parameters for the RP3 period 2020-24, with clear signposting of what assumptions are included in arriving at these estimates.

At a later stage, a fuller cost of capital study will be commissioned. The reason we do not include economy-wide parameters at this stage of the process is due to the interaction with the H7 programme. Work has already been commissioned on the cost of capital for HAL at H7.

## Deliverables

The advisor will be required to provide a preliminary view on the allowed cost of debt and the equity beta. This should be in the form of a suitable range rather than a point estimate.

A short report should be prepared on each of the two parameters, setting out the analysis conducted and the views of the advisors. The underlying data used in this analysis is expected to be provided to the CAA.

## Review of NERL pension costs

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### Objective

To advise the CAA on:

- the actuarial assumptions that NERL has adopted in estimating the pension contribution costs within its business plan for RP3; and
- NERL's stewardship of the pension plan, in conjunction with the Trustees, over the period 2016 to date.

### Scope

The CAA is seeking advice on three issues relating to pensions:

- the implementation of the stewardship test;
- changes made to mitigate the cost of the defined benefit scheme; and
- the actuarial assumptions underpinning the estimated pension costs that NERL will include in their business plan.

The stewardship test is intended to ensure that the charges that users pay reflect the efficient management of the pension scheme's assets. The test would involve the fulfilment of requirements of pensions legislation and the codes of practice under the Pension Act 2004. The CAA also seeks the advisor's views as to whether these requirements have been met without unreasonable cost or cash contributions from NERL.

### Deliverables

The advisor will be required to provide a view on each of the three issues noted above and whether the assumptions in the Initial Business Plan are correct.

The main deliverable will be in the form of a report. This will be commissioned alongside work on the valuation of the pension deficit, made using data to the end of 2017.

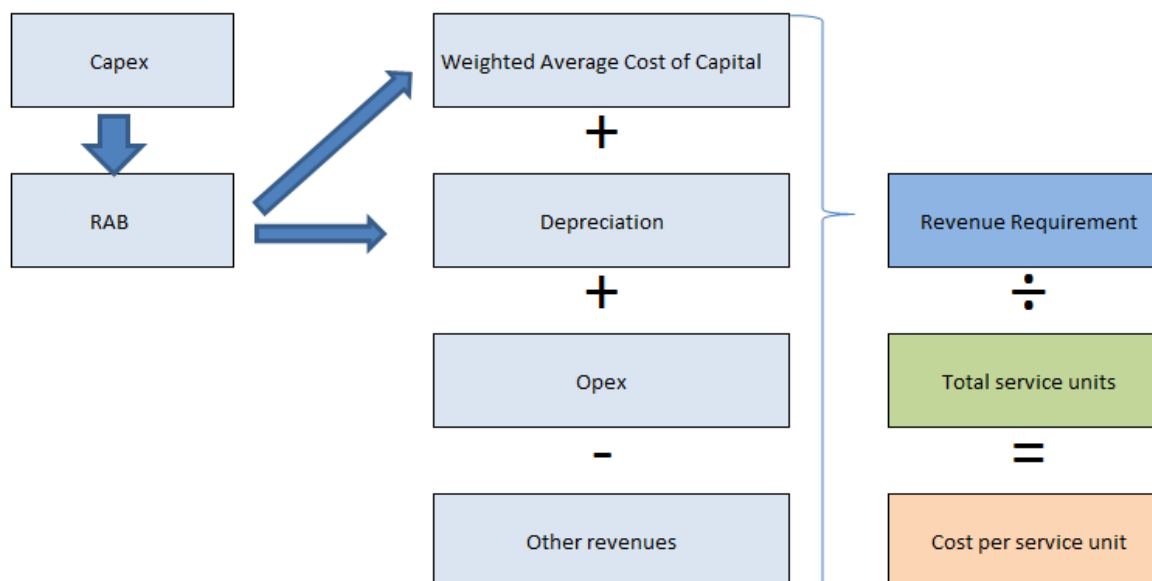
Interactions between these separate reports will need to be considered.

## APPENDIX E

# Building block approach

At RP2 NERL's charges were calculated on the basis of a 'building block' approach illustrated below. This highlights the key components that influence and therefore determine prices. It is a standard approach in UK economic regulation and is well understood, and valued, by investors as it helps underpin their long term confidence in the regime.

Under this approach capital expenditure is not allowed in the year that it is incurred but is added to the RAB and financed by allowances for regulatory depreciation and returns, reflecting the relatively long life of capital assets and the potential for year by year volatility in capital spending. These two building blocks (regulatory depreciation and returns) are then added to an allowance for operating expenditure, which in NERL's case may include a substantial allowance for pension costs, to make up the company's revenue requirement. Any non-regulated or other revenue is then taken into account in assessing the appropriate level of regulated revenue as illustrated below.



This building block approach is not formally provided for under SES Performance framework, but operates in parallel to meeting the requirements under charging regulation.