

# Appendix C: Setting future price controls – lessons learnt from the review of approach

CAP 3000a

## Contents

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# Lessons learnt workshops with HAL, NERL and airlines.

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## Introduction

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During February 2024, we held eight workshops with NERL, HAL and airline customers on the lessons learnt review. This appendix provides a summary of stakeholder views from these workshops. These summary notes were prepared by the CAA and reflect comments from HAL, NERL and the airline community on these notes as appropriate.

These notes should be read in conjunction with the complete responses from HAL, NERL and the airline community to the consultation: Setting future price controls – review of approach (CAP 2618). On their own, the notes are only a summarised representation of the points discussed verbally during the workshops held by the CAA before the responses were submitted, and therefore do not reflect stakeholders' full opinions on these issues.

The term "airline" is used to refer to views expressed by particular airlines in the workshops. This does not imply that each point raised was shared by each airline present at the workshops. The responses from individual airlines are published on the CAA website with CAP2618.

## Workshops with NERL on NR23

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### NERL's views on Process and Governance, 9 February 2024

#### Objectives for the next price control

- CAA should develop a framework that will enable incorporation of new airspace users, to keep the costs and charges for such new users separate from price regulation for NERL's existing en route services, and to allow NERL to make appropriate investments to ensure a safe and resilient service.
- On environmental sustainability, the CAA should consider whether the current metric is sufficient and appropriate given the wider government policy for net zero in aviation. Unlike other regulators, or the CAA's role in airport regulation, for its regulation of NERL there was at present no requirement to consider environment factors – the CAA should consider seeking statutory guidance from the Secretary of State, and look at other the approach of other regulators.
- Concern that airlines will prioritise capacity over sustainability in the future which could make reaching sustainability targets more difficult.

- On investment, the future CAA framework should be more flexible between capex and opex as NERL faces choices for example whether to invest in procuring software (treated as capex) or buying software as a service (“SaaS”), which would be treated as opex. Some concern that stakeholders may not fully understand the complexity of NERL’s software investments. NERL plans to engage earlier and more frequently before the submission of business plans.

### **Proportionate and transparent regulation**

- CAA should provide more detailed business plan guidance and a roadmap of where it needs to provide information.
- The CAA’s approach to asking questions on NERL’s business plan (questions not always themed or clearly expressed) meant responding to this was time consuming. It suggests using an online interactive platform for asking and responding to questions.

### **Business plan guidance**

- CAA’s business plan guidance was not particularly helpful. There was a short space of time between the CAA guidance and NERL getting Board approval for its business plan. Earlier guidance could have led to more in-depth consultation rather than a lot of questions being asked afterwards.

### **Customer consultation**

- Positive experience with the hybrid in person and tele-meeting model and with co-chair approach to the customer consultation working group.
- Some customers saw these consultations as more a “show and tell” rather than an opportunity to steer the direction of the business plan.
- Having more Constructive Engagement with airlines on the direction of travel would be useful, but this needs to come earlier in the process if it is to have any real impact on the business plan.
- Suggestion to focus on the areas where the impacts are most material and the outcomes the stakeholders want to gain from the price controls, as explaining the reasons for choices in the business plan can be difficult.
- CAA should set expectations for the meetings that material should be reviewed before meetings and that airline attendance includes operational specialists.

### **CAA stakeholder engagement**

- Disappointed that the timing of the price control was changed during NR23.
- Where issues were raised on topics such as pensions, inflation, and service quality targets, these could have been signalled as an issue earlier on.

- CAA guidance on the reconciliation review for RP3 was high-level and led to some uncertainty on behalf of NERL.
- There should be flexibility for detail in the business plan to change over time. For example, during RP2 NERL was asked to submit book-end ranges on costs for customer consultation, which worked well.
- It would be useful to be supplied with worked examples to explain the more complex areas of the CAA's decisions.

### **Process management**

- In general, NERL notes that its responses to information requests were provided on time. NERL responded to around 200 requests for information within six working days on average and advised the CAA if information was to be submitted later than five days.
- The CAA should set expectations on timing of responses at an early stage and meet its deadlines without too many extensions.
- CAA should group the queries it sends in a more organised way.
- It would have been helpful for the CAA to provide regular briefings on papers going to Board and timetable updates.

### **Timetable**

- The CAA should follow the approach taken by other regulators to provide a month-by-month timeline for the next two to three years for the price control.
- Disagree with moving the start of NR28 and consider that the CAA should seek to make a decision on NR28 by 2027.

## **NERL's views on Building Blocks, 14 February 2024**

### **Incentives and traffic forecasts**

- Good alignment during NR23 on the use of the STATFOR traffic forecasts. Near the end of the review it was difficult to quickly update service quality targets to reflect the latest traffic forecasts.
- There was a significant dialling up by CAA of the quality service targets without a full exploration of trade-offs. Proposals for more incentives should be justified with respect to the performance gap they are trying to close.
- The delay to the NR23 Final Decision meant the regulatory process consumed the first year of the price control period, which reduced NERL's ability to implement efficiency improvements.

- Potential risk of unintended consequences if incentive targets were stretched too far, there is a need for an overall balance.
- The capex engagement incentive scores should be made more objective and suggests looking at other ANSPs for comparison.
- The Traffic Risk Sharing (“TRS”) mechanism during NR23 was a good example of a well-delivered regulatory outcome in a difficult environment. But NERL’s proposal for a TRS mechanism for its Oceanic business was not properly considered by CAA and was dismissed as being too complex.
- On service quality, the environment versus capacity trade-off could be given more consideration going forward and question whether CAA can give more weight to environmental matters.
- Consumer voice should be more incorporated and this engagement should take place early in the process.
- On cost incentives, the RPI-X framework worked well historically to improve efficiency, so limited benefit in strengthening incentives. Questions on the value and purpose of the newly strengthened capex engagement incentive and how this is balanced with other service incentives – there is a much larger potential penalty for the capex engagement incentive, compared with delay and environmental performance, which were much higher priority areas for airline customers.

### **Cost Assessment**

- The work of the external consultants for the CAA was overall reasonable, logical, accessible and allowed for good response and challenge from NERL on areas of disagreement. The follow-up questions in Spring/Summer 2022 were not as well managed and it was sometimes difficult for NERL to provide responses in an efficient manner.
- The delay to the NR23 timescales had a knock-on impact on NERL’s plan and costs. While CAA did allow for updates, this was complex because of interdependencies within the business plan.
- The external environment changed materially in terms of delivery of software or IT options, but the current regulatory framework has no mechanism to switch between opex and capex. CAA should consider this issue as part of NR28.
- CAA could have made more use of European data on ANSP performance (cost effectiveness and productivity).
- The timetable for customer engagement was very tight. NERL would like to do this in two stages going forwards: strategic discussions with stakeholders at executive level, before more detailed discussions.

## **Environmental Sustainability**

- During the price review, there had been strong support from CAA for airspace investment contributing to environmental sustainability (for example, improved flightpaths). The CAA could do more outside economic regulation to improve environmental outcomes, such as making the airspace change process more efficient.
- Trade-off between environment and capacity could be more fully considered if CAA were given the appropriate locus to do this, for example to consider Ministerial guidance on environment issues (as provided for in the Transport Act 2000).
- NERL is planning a review of the 3Di measure ahead of NR28, and whether there are complementary measures that are better understood or relate more closely to airline performance. It wants to work with CAA on this and plans to present analysis in Q3 2024 to facilitate discussion on calibration of this metric.

## **RAB and Financeability**

- CAA should get the price control model ready before the start of the price review. NERL is updating its financial model and will continue engaging with CAA on these issues.
- The CAA took a simpler approach to equity financeability and should consider more scenarios and the asymmetric downside risk on NERL. The asymmetric risks were factored into H7 assessments but not for NR23.

## **Simplifying the regulatory calculations**

- The test should be whether complexity affects management of the business. NERL considers this is not the case – the NERL team understands the detail and a robust model can handle these mechanisms. NERL will consider areas for simplification, but it is not an objective in itself.
- The RAB rules document could be simplified for NR28 for easier interpretation.

## **WACC**

- Continuity of a well-established approach and consistency with other regulators can be good for investor confidence, though need to reflect unique nature of aviation.
- NERL will consider proposals to change RPI to CPI indexation.
- NERL would like to see more use of comparator companies including ENAV.



## Workshops with HAL on H7

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### HAL's views on Process and Governance, 14 February 2024

#### Objectives for the next price control

- Some potential themes for H8 include strengthening the consumer voice, scaling the airport to meet demand, reflecting Government aviation and environment priorities, and developing a more balanced approach to prices and outcomes.
- Timeliness and predictability of the CAA progress is important as well as delivering against a clear timetable, which is shared with stakeholders in advance.
- CAA could consider experiences from other regulators and whether the length of the regulatory cycle is aligned to sector characteristics and objectives.
- The current single till approach does not support investment around the airport, for example in off-site property, long-stay car parks and cargo facilities.
- The Market Power Determination is outdated (from 2012) and could be refreshed, taking account of the current market conditions and industry dynamics.

#### Proportionate and transparent regulation

- Regulatory interventions should have a clear evidence base to ensure transparency and proportionality of response.
- Before implementing new policies, the CAA should review existing policies to see what impact they had, whether they remain fit for purpose, and if they should be updated.
- The H7 framework for capex and other regulated charges ("ORCs") adds more complexity, burden and requires more agreement among stakeholders. This reduces HAL's decision making powers to better reflect consumer needs.
- The new capex framework requires significant work and adds complexity, delaying capex delivery. The framework needs to enable longer term investment which is in consumers' interest. The issues faced with the T2 security programme exemplify how the framework drives disagreement between HAL and airlines.
- There is scope to restructure the ORCs framework to include some items in airport charges and consider consumer interests.

#### Business plan guidance

- Issues with CAA business plan guidance where expectations led to disagreement between stakeholders.

- CAA should provide more detail on what it expects in a “high-quality” business plan and should recognise that not all the information will be available at the time of submission. CAA should provide questions earlier in the process to allow HAL to answer in time.
- In H7, the guidance for business plan did not come up until two weeks before submission. Should be more time between the publication of business plan guidance and the deadline for submission (potentially around six months) for HAL to mobilise adequately and reflect the guidance more fully in its plans.
- CAA governance is not designed for short-term requests, so need a longer and clear timetable.
- Formal information gathering powers are not necessary. Focus on a clear timetable and more engagement. HAL will provide the highest quality information it has available.

### **Constructive Engagement**

- Constructive Engagement is helpful in some ways as an engagement tool that allows HAL to provide more information to airlines and them to develop some level of scrutiny.
- Should be a better understanding of the CAA’s role in Constructive Engagement, with CAA clarifying its expectations and providing views on the broader strategic options to clarify policy priorities rather than focusing on specific details.
- Constructive Engagement not the only opportunity where airlines can influence the business plan. Airline engagement ahead of developing the business plan, such as on capex and service quality, already happens through other forums and does not need to be a formal part of Constructive Engagement.
- Constructive Engagement is difficult to do before the Initial Business Plan is available and difficult to submit the business plan before the regulatory framework is locked down. A more focused Constructive Engagement could discuss choices and options.

### **CAA Stakeholder Engagement**

- Should be wider stakeholder engagement, providing consumers with a stronger voice, for example with the Consumer Challenge Board (“CCB”) and the Heathrow Area Transport Forum (“HATF”). The CCB helped test HAL’s consumer engagement questions.
- Benefits from more bilateral engagement between HAL and CAA on business plan details. CAA should provide visibility on who leads on each policy area.
- CAA should attend ongoing key forums at Heathrow (e.g. “CPB”, ORCs) to better understand what is going on outside of the price control review process.

- Should be a forum to explain CAA process to allow other types of stakeholder to engage more in the price control review.

### **Process Management**

- The price review timetable needs to be credible from the start and the CAA should consult on its timetable, noting Ofwat sets the timetable with specific dates two years in advance. The CAA also needs to stick to timetable plans.
- Early engagement between CAA consultants and HAL is key to a more effective process. In H7, information from consultant studies was published before they had even engaged with HAL. It is important that CAA plans their need for external support early on giving HAL an opportunity to comment on these plans. A clear timetable for consultancy studies would be helpful and would allow HAL to engage with the consultants while they are engaged by CAA.
- Issues at H7 where consultants undertook substantial initial work without any HAL engagement. Early engagement with consultants would avoid repeating this.
- CAA's internal governance appears to be a source of delays at times. To help with this, the CAA could establish a Regulatory Board with Non-Executives from an economic regulation background, as an expert panel reporting to the main CAA Board, providing advice and decision-making.

### **Timetable**

- The price control review timetable needs fixed dates as done by Ofwat. This will require substantial planning work.
- Based on the CAA's view on the H8 timetable in CAP2618, which is already delayed and where the H8 final method statement is initially planned for late 2024, an Initial Business Plan submission in early 2025 would be very challenging and mid-2025 is more realistic.
- CAA timelines need to be reliable and credible. Given existing delay in relation to indicative timeline CAA needs to be open and upfront about managing possible impacts to the start of H8.
- There should be a sufficient period between the CAA's final method statement and HAL's Initial Business Plan so that any guidance and policy decisions can be more fully incorporated.

## **HAL's views on Building Blocks, 19 February 2024**

### **Incentives and traffic forecasts**

- The incentives were well understood but concerns over the detailed implementation in some areas. Some challenges in the overall package of incentives and how costs were estimated. Concerns the CAA passenger forecasts were too optimistic.

- The approach to passenger forecasts for H8 will need to be different to H7 as Heathrow will be capacity constrained and so focus on airport capacity and airline operations. So forecasting is much less about economic demand, but dominated by how capacity is made available and use of slots.
- Some difficulties understanding H7 CAA's forecasts – should be more transparent for example, so that assumptions can be checked against actuals.
- External forecasts only help if it gets to a huge amount of detail. General UK aviation growth factor does not work for Heathrow.
- Capacity constraints mean traffic risk sharing should reflect asymmetry in outcomes as it will be more difficult to increase passenger numbers above the forecast. Should be a focus on downside risk for passenger variations more than 10%.
- The service quality regime needs to be based on consumer input through research and independent consumer group. Service quality scheme is working well and outcomes based regulation (“OBR”) is not a material change in comparison to previous SQRB scheme. HAL is considering a more consumer focused approach for H8. Should account for interactions between incentives to avoid constraints on airport operations.
- The CCB worked well in many respects and an independent panel could challenge both HAL and airlines.
- Other potential improvements include: rebates going direct to consumers; increase flexibility in airline approval process for asset maintenance; simplify runway operational resilience measure; improve balance of rebates and bonuses; review allocation of risks between HAL and airlines; and consider incentives for commercial property revenues.
- Too soon to strengthen capex incentives. CAA should provide more guidance to support HAL's engagement with airlines. Framework is not driving efficient outcomes and there is scope to investigate best practices in this area.

### **Cost assessment**

- A key issue was accuracy of the opex assessment. Actual opex was much higher than the H7 allowance in the first two years of H7 as a result of HAL choosing to invest in the service customers get. Reductions cannot be delivered without impacting service. HAL's challenging forecast developed during the price control process proved to be a closer estimate.

- This lack of accuracy could have been mitigated if the CAA had considered fully the evidence provided by HAL. HAL provided 2022 forecast on energy costs, but the CAA continued to consider 2021 forecast information within its Final Determination. The CAA also did not consider the likely lower level of business rates or the impact of the removal of VAT refund scheme on airport shopping. Furthermore, the CAA estimates also double-counted efficiencies that Heathrow was achieving.
- A five-year repayment period on capex projects is not aligned with the characteristics of real estate development and leads to an underinvestment in property that harms consumers.
- CAA assessed efficiency bottom-up rather than looking at overall allowance, and a different approach to cost estimation might have been more robust.
- Benchmarking costs is useful. HAL developed a report with KPMG using best practices to compare costs across airports. In relation to data during covid-19, need to consider the varying levels of government support received by airports during the pandemic.
- For H8, need to take more account of consumer views, consider any new government priorities and policies, and a broad focus on carbon and net zero.
- The CAA will also need to check assumptions against the reality of the business (this was not the case in H7 and costs in building back up after the impact of covid-19); provide further transparency around assumptions and models used by consultants; and work to ensure timely provision of these assumptions under a clear timeline that allows HAL to mobilise resources accordingly.

### **Environmental sustainability**

- H8 is a critical period and need a plan to address the long-term challenge. Net zero is a legally binding target so need clarity how CAA will enable HAL to meet this. Extensive engagement towards the end of the H7 price control was key to support the outcomes achieved. This needs to be intensified for H8.
- There will be a high degree of uncertainty with relative immaturity of technology and in identifying the decarbonisation trajectory that needs to be reflected.
- A switch from fossil fuel to electricity is key to decarbonising Heathrow, requiring a change in the airport energy infrastructure. H8 needs to enable the capital investment needed for infrastructure upgrade/ adaptation.
- ORC framework will also be key to help deliver this given the investment in infrastructure and the ORC framework will need to be reviewed.
- As Heathrow airport moves to a reliance on electricity, airport resilience and climate adaptation strategy will need to be considered.

- A key element of environmental sustainability in H8 is climate adaptation, also a policy priority for DfT. H8 price control needs to also focus on the funding arrangements for this investment.

### **RAB and Financeability**

- Changes to the approach to indexation during the H7 process should have been consulted on to reduce unintended consequences.
- The depreciation rates used by the CAA no longer align with how HAL applies depreciation and are no longer suitable.
- The approach to credit rating should have been targeting a BBB+ rating for the notional company. More thought should go into equity financeability (cost of equity being lower than cost of debt is challenge to equity financeability as it becomes less attractive) and the credit rating required for expansion.
- CAA should review approach to setting the WACC for H8. Taking the CMA's decision as a starting point would not be adequate – the CMA did not agree that the CAA was correct, they simply did not find that the CAA was wrong given the huge degree of latitude given.
- Capacity constraints mean substantial investment will be needed ahead. Pressures to scale the airport to meet growing demand as Heathrow reaches capacity mean that HAL needs to continue demonstrating financial resilience to access capital.
- Concern that the cost of equity is below the cost of debt.
- While airport charges reduced this year, there was no reduction in airline fares, raising question whether this has protected consumers.

## Workshops with airlines on H7

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### Airline views on Building Blocks, 15 February 2024

#### Incentives and traffic forecasts

- CAA should consider the aims of the incentive mechanisms, the cumulative effect and implementation issues. Incentives should be seeking to reflect the asymmetry of information, ensure continued economy/efficiency and avoid regulatory gaming. For instance, there were information asymmetries during the Constructive Engagement process on HAL's business plan, such as passenger forecasts, opex and commercial revenue and service levels. CAA should consider incentives to address these risks.
- The 50:50 split in risk for traffic risk-sharing does not reflect information asymmetry between airlines and HAL. HAL's passenger forecast for H7 was inaccurate and risk-sharing should be rebalanced so that a higher proportion of the upside is shared compared to the risk sharing for downsides, particularly given HAL are now forecasting traffic to be close to the capacity cap meaning there would be limited upside.
- Suggest using an external passenger forecast for H8.
- CAA should consider opex efficiency sharing or a RAB-based incentive to avoid the risk of inflating forecasts in business plan submissions.
- H8 should focus on passenger experience, drawing on examples from international airports that excel in this area.
- Airlines have questions on whether the current service quality regime is achieving its aim and how performance is measured. Should look at daily measurement and remove the service level bonus as HAL is delivering what is expected of an airport infrastructure provider.
- Passenger engagement surveys are conducted by HAL and then sent to airlines and CAA. CAA leading on this would be more transparent and give stakeholders greater confidence in the results.
- Still early days for a number of new incentives, the CAA will need to consider how it will be monitoring developments and factoring into the process e.g. with *ex ante* incentives and Delivery Obligations, this has driven greater risk costs at G3.
- Support the *ex ante* capex efficiency incentive regime introduced by the CAA in H7 and support its continuation but highlight the need for clearer and speedier CAA guidance and intervention on implementation and where the regime is not followed.

## Cost assessment

- Stressed the lack of transparency during Constructive Engagement over key elements of HAL's "driver-based" business plan, including capex and opex. Felt there was lack of detail and granularity in information provided by HAL and it was variable in quality and depth across different cost areas.
- Users were unable to challenge meaningfully and there were significant differences in views. This resulted in bringing in consultants for issues such as H7 opex at a late stage, where its view aligned with airlines. Also, CAA did not reflect all recommendations from its independently commissioned reports in the H7 decision or give these equal weight with the studies produced by HAL.
- CAA should take a more active role in Constructive Engagement and encourage more information sharing between HAL and the airlines.
- Challenged the use by the CAA of HAL's estimates as a starting point in its efficiency assessment and the perverse incentives this creates. Noted that the CAA should adopt a view based on using the most appropriate approach in its toolkit, such as bottom-up assessments.
- Airlines should have more say in how HAL manages ORC costs as they have more of an incentive to reduce these than HAL.

## RAB, WACC and financeability

- The vast majority of charges at Heathrow are being driven by the size of HAL's RAB, which is much larger than other European hubs. Over the past decade the RAB has increased sharply and almost doubled despite higher depreciation. Given its impact on charges, the size and growth of HAL's RAB should be dealt with as a priority.
- A significant contributor to the growth in HAL's RAB is the inflation indexation, which has driven significant windfall profits for HAL in the past decade. There is merit in the CAA examining a move from RPI to CPI indexation in line with other regulators.
- The CAA should examine assets including in the RAB that are potentially underperforming and consider whether these are better divested (for example, car parks). It should equally examine the inclusion of an equal rate applied to each project for Leadership & Logistics.
- On financeability, a relevant question is not whether HAL "has enough" but also whether it "has had too much". In doing so, CAA should look historically at HAL's profitability as well as recent market evidence, such as the valuation from the sale of Ferrovial's stake.



- On the WACC, the CMA H7 decision is a logical starting point but will need to be adapted given the unusual covid-19 context, emerging precedent from the UKRN, other European airport charge regulators and the Thessaloniki Forum guidelines. Updated market evidence should be looked at to assess if the return allowed is appropriate. Fairly strong view on long-term approach and excluding atypical events.
- The asset beta was not reflective of the risk to HAL. The CAA should consider an adjustment to the betas of chosen comparator airport groups to reflect their different activities to HAL – for instance non-European airport operations.
- Request for further technical session on the RAB and WACC.

## **Airline views on Process and Governance, 21 February 2024**

### **Objectives for H8**

- CAA should set out its strategic vision for how its price controls will deliver against its primary duty to protect consumers. This statement should set out measurable objectives, lay down the factors to be considered when assessing the consumer interest (such as value for money, affordability, service) and explain how it will balance its primary duty against other secondary duties such as HAL's financeability. This allows CAA to set out its approach for the price control and plan its work upfront in a proportionate manner.
- Should reflect the future of aviation, including automation, and consumer views. The CAA should conduct its own consumer research in this area.
- Should consider the capabilities (capacity, resilience, performance and experience); costs (addressing the key drivers for both aeronautical but also operating at Heathrow); and governance (improved decision making and accountability)
- The CAA should set out its approach for how it will monitor and implement the H8 price control.
- Do not support a market power determination ("MPD") for Heathrow, as it shows behaviour of market power and the factors from the CAA's last MPD are still present.

### **Environmental sustainability**

- The framework does not prevent sustainable decisions by HAL; this is a core pillar of their corporate strategy and there are already with a number of requirements and levers HAL has and uses. Need to be clear on what issue the CAA is seeking to address.

- Investment business cases on sustainability should be held to the same robust standard as other investments, looking at cost effectiveness. Airlines are not always shown all optioneering information for projects.
- Sustainability investments still need to demonstrate measurable objectives and positive impact on consumers.
- Whilst a fundamental matter for industry, sustainability is also wider than carbon.

### **Proportionate and transparent regulation**

- CAA should use its information gathering powers and enforcement where information is not provided.
- CAA should be more proactive in sharing timelines and changes during H8.
- CAA should review its internal Board processes to make it more effective and targeted, such as using delegated authorities where needed.
- The H7 process was frustrated by limited transparency on the building blocks, particularly opex, commercial revenue and ORCs. CAA should focus on most material building blocks, including the RAB and WACC, and material issues / drivers of the building blocks.
- Should be auditing of the RAB. This could introduce sign-off from CAA, and airlines on future additions to the RAB.

### **Business plan guidance**

- Support strengthening the CAA's business plan guidance and using enforcement powers if information is not provided to compel its provision, impose penalties and disallow revenues.
- CAA could review other regulators' business plan guidance.
- CAA should set an expectation of the minimum information expected of HAL, such as templates and a detailed cost model.

### **Constructive Engagement**

- Constructive Engagement was unsuccessful in H7 due to lack of transparency, significant information asymmetry and lack of meaningful consultation with airlines. HAL's business plan was "driver-based" and did not provide sufficient detail, granularity or optioneering on the key elements such as opex and capex. The model on the passenger forecast was not provided and was overly pessimistic when compared with outturn traffic. Airline views were not given the same consideration in some areas as HAL's views.

- CAA should take a more active role in Constructive Engagement, set clear expectations from the beginning and step in where an impasse occurs. This was the approach set out by the CAA for Gatwick's Q6 Constructive Engagement mandate. CAA should do monthly check-ins with parties during Constructive Engagement to resolve issues as they come up.
- Constructive Engagement should be timely and take place at an earlier stage so discussions can influence the initial business plan. The CAA should also consider a proactive role during the development of the initial business plan, such as pre-notified milestones with HAL to ensure confidence in the quality of the document.
- There could be collaboration in using external consultants during Constructive Engagement (for example using tripartite engagement), and confidentiality rings could be considered where sensitivity concerns exist.
- CAA should conduct its own consumer research and not rely on HAL's research.
- CAA should set the WACC, rather than this being a topic of debate during Constructive Engagement. It should nevertheless provide a steer to inform the discussions during Constructive Engagement.
- The financial model used during Q6 was more user friendly than at H7, and that this could be used for H8 during Constructive Engagement.

### **Stakeholder Engagement**

- Fortnightly calls with CAA and access to the CAA Board were useful. Airlines would like continued senior level engagement with the CAA team and Board.
- There should be frequent structured engagement at senior and working level, with the CAA providing clear information on the programme, timing of consultation and updates on process. Meetings should have clear agendas and documented actions.

### **Process Management and Timetable**

- There should be more enforcement of deadlines and clear timelines. Similarly, there should be improved monitored and enforcement of HAL's compliance with its licence and the CAA should be prepared to use its enforcement powers. A CAA monitoring and enforcement team on economic regulation would enable those tasks to be carried out.
- It is critical, and the airlines are supportive, that the CAA strengthens its resourcing to deliver H8 at the current timetable and implement the price control. The CAA should consider early consultant involvement to alleviate any issues.
- CAA should have regular catchups with HAL before the business plan to ensure it is on the right track and will supply detailed information to CAA and airlines.
- CAA should include time during summer 2024 to implement the lessons learnt.

## Workshops with airlines on NR23

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### Airline views on Process and Governance, 22 February 2024

#### Objectives for NR28

- CAA's objectives should be set out early in the process. CAA should set out its strategic vision for how its price controls will deliver against its duties, providing an indication of the balance and proportionality applied across the CAA's primary and secondary duties in the Transport Act 2000 ("TA00").
- This statement should set out measurable objectives, lay down the factors to be considered when assessing the consumer interest (such as value for money, affordability, service) whilst clearly defining the CAA's calculation of subjective matters such as affordability. This will allow the CAA to set out its approach for the price control and plan its work upfront in a proportionate manner.
- Airspace modernisation will be an important element in NR28 to meet environmental targets and a more efficient airspace in terms of capacity provision and costs. This is an important and long-standing priority for airlines.
- NERL's capex plan will need to be reviewed carefully, including the *ex post* efficiency assessment for RP3 and NR23, particularly the technological transformation ('legacy escape') programmes.
- Airlines support the continued engagement of the independent assessor and new incentives for engagement and delivery of the investment programme. Greater separation, and potentially ring-fencing, of 'legacy escape' programmes is required for NR28. There is a need for clearer and quicker CAA guidance and intervention on implementation and non-compliance.
- Incentives for NERL's capex delivery require consideration. NERL's adoption of a 2+5 planning approach for its capex also appears to warrant further consideration towards how the capex envelope is established and if current mechanisms appropriately address this area.
- The CAA should set out its approach for how it will monitor, implement and enforce the NR23 and NR28 price controls. The CAA should produce an annual report on the price control, mirroring European best practice, and reinstate the annual ATC Charges Consultations to allow airlines to engage directly in the process of monitoring and reconciliation of previous performance in all areas.
- There has been an increase in charges but without a proportionate increase in service quality. Airlines want to know what regulatory remedies the CAA will be planning to set up according to its statutory duties of consumer's protection.

- The 3Di metric could be enhanced for NR28 and CAA should review the modulation of metrics with the collaboration of users and NERL and explore the enhancement or replacement of 3Di as a metric.
- A large portion of delays in summer 2023 were attributable to NERL and therefore CAA should review service quality incentives. NERL should be held accountable for discontinuity in service provision. CAA should consider whether the incentives should be strengthened and compensation mechanisms should be introduced.
- Airlines want an in-depth review into how to hold NERL accountable for major incidents. The gaps in service quality metrics, such as for interruption of services, mean there is a lack of proportionate accountability for major incidents and ATM delays. Any outputs from the independent review of the August 2023 incident should be duly considered for adoption in NR28.

### **Proportionate and transparent regulation**

- CAA should use its information gathering powers and enforcement where information is not provided in full or to the level of detail required by the CAA.
- The CAA should ensure it is fully executing its role as the National Supervisory Authority and economic regulator for NERL, including putting requirements on NERL to deliver service quality and affordability of services.
- CAA should be more proactive and timely in sharing timelines and changes during NR28.
- CAA should review and simplify areas of the framework before the price review, including traffic risk-sharing and indexation of the RAB. Interventions due to the impact of the covid-19 pandemic have added significant complexity.
- CAA should conduct a complete assessment of NERL's opex, including benchmarking. The CAA should ensure it appropriately sets efficiency allowances.
- Do not support separate price control review processes for Oceanic and London Approach.

### **Business plan guidance**

- The optioneering and scenario analysis in NERL's business plans was limited and there was limited engagement with airlines on this. Airlines were unable to appropriately assess the drivers of NERL's business plan under a range of scenarios.
- There was also a lack of transparency on business cases for the capex programme. There should be more transparency in key areas such as the capex programme, opex, growth assumptions and productivity. It is important that the relationships between building blocks and effects of options are presented to enable a transparent business plan to be developed with airline input.

- CAA should consider condensing the price review process to maintain more continuity in stakeholder engagement.
- Support strengthening the CAA's business plan guidance and using enforcement powers if information is not provided to compel its provision, impose penalties or disallow revenues.
- CAA should monitor NERL's delivery of the business plan regularly, on a quarterly or half year basis, to understand how activities progress and evolve during the price control. The CAA should publish an annual report on NERL's performance compared with the price controls and to highlight the key areas around cost, TRS and service quality. This would provide more clarity on carryovers for NR28 and allow airlines to actively engage in the monitoring process.

### **Constructive Engagement**

- Earlier and more detailed engagement is needed to have an influence on NERL's business plan.
- Airlines are often given in-depth, wide-ranging information with a short deadline for review before a Constructive Engagement meeting. They would like to see more targeted and relevant information sent at an earlier stage.
- CAA should have a more active role, especially in resolving and noting areas of disagreement that subsequently require attention by the CAA. The CAA should consider engaging with NERL at an earlier stage to establish its business plan guidance and consider its scheduling and duration of activities within the CAA's NR28 delivery timeline.
- The CAA should set a provisional WACC range before Constructive Engagement so this is not an issue for debate during Constructive Engagement. It should nevertheless provide a steer to inform the discussions during Constructive Engagement. The CAA should expect that the WACC will require its detailed attention as part of setting the price control.

### **Stakeholder engagement**

- In general, CAA engaged well with stakeholders.
- There was some confusion on the way the CAA presented charges in the Final Decision and it should clarify these for NR28. In particular, the recovery of the covid TRS debtor amounts and the smoothing of the price path made this unclear. Clearer explanation and consistency of terms would be beneficial, particularly in summaries. Simple Excel tables can be shared to help support airline understanding of the adjustments and charges.
- CAA should explain changes between its Draft and Final Decisions, and which bits of evidence were considered and why judgements were reached.

- Delays and lack of notification of such instances in the price control led to issues with users' resources, including consultants.

### **Process Management and Timeline**

- There should be more enforcement of deadlines and clear timelines. Similarly, there should be improved monitored and enforcement of NERL's compliance with its licence.
- CAA should set higher expectations on information it expects to receive earlier in the process and should use enforcement powers to meet deadlines and reduce information asymmetry.
- CAA should consider a delegated authority from the Board for appropriate elements of decision making.
- CAA should have regular catchups with NERL before the business plan to ensure it is on the right track, is clear on the requirements the CAA is placing on it and that NERL will supply detailed information to CAA and airlines.
- The CAA should consider early consultant involvement to alleviate any issues.
- Access to the CAA Board was beneficial and should be retained for NR28.
- Constructive Engagement should start earlier to enable airlines to input to the formation of the business plan, especially explore options and scenarios with NERL before a full business plan has been created. This should be followed with greater depth of engagement with airlines to refine NERL's business plan before it is finalised.
- CAA took a relatively long time to review the business plan compared with the time allocated for Constructive Engagement.
- Timelines for airlines to assess and respond to CAA publications was too restrictive, limiting the extent that users could appropriately assess, engage internally and consultants, complete governance requirements and provide full responses.
- CAA should include engagement with the CAA Consumer Panel on the timetable.
- Do not support a 1-year delay to the NR28 price control.

## **Airline views on Building Blocks, 23 February 2024**

### **Incentives and traffic forecasts**

- Support an independent data source for traffic forecasts (e.g. STATFOR). Consideration also required for the development of an independent source of traffic forecast for Oceanic services.

- Traffic risk-sharing put an unfair risk on airlines, given the large downside from the impact of the covid-19 pandemic, but no large upside during normal operations. The calibration of the TRS should be considered further, including for extreme outlier events. CAA should confirm up front the level of traffic deviation where it will consider exceptional measures, such as those applied in its assessment of efficient costs during the covid-19 pandemic period.
- The CAA should consider strengthening capex engagement and delivery incentives, and monitoring and enforcement. It should be mindful of their calibration and the balance of risk across the price control. CAA could consider expanding the capex engagement incentives to opex.
- CAA should clarify the aim of the service quality incentives, and ensure appropriate scope, strength and balance in the package of incentives. It should consider the findings from the independent review of the August 2023 incident, including consideration of balance of liability and risk held by airlines and NERL.
- The CAA should play an active role in the review of NERL's environmental metric, 3Di.
- Cancellations, the same way as delays, should be incentivised as these cause significant disruption to airline operations, noting the impact of the incident in August 2023.
- CAA should address the information asymmetry between NERL, the CAA and airlines.
- NR28 is an opportunity to review the service quality and performance metrics and targets. These should be ambitious enough to drive positive change, encourage appropriate behaviours by NERL and should be proportionate.
- There is difficulty in reconciling the charges appearing in the Eurocontrol submissions with the CAA's decisions.

### **The RAB and financeability**

- Airlines are concerned with inflation indexation of the RAB. The CAA should consider the compounding effects and windfall profits for NERL. There is merit in the CAA moving from RPI to CPI indexation in line with other regulators. CAA should consider using a nominal WACC, but if indexation is retained then they support a change from RPI to CPI indexation.
- The treatment of TRS debtors from the covid-19 pandemic and its inclusion in the RAB should be considered. The CAA should assess TRS debtors generated from significant traffic variations and it should provide an *ex ante* statement of how the CAA will approach any such extreme event in future.



- CAA assessment of return should focus on what is the right level of return for a monopoly service provider such as NERL, taking account of its risk profile. The credit rating methodology measures default risk, which is not applicable to a business like NERL. A measurement of the return on capital employed or other profitability indicators are better suited to understand if NERL's return is too high compared to an appropriate level of the WACC.
- Like the Performance Review Body, the CAA should commission annual independent assessments to ensure that NERL's business plan delivers on its objectives and that NERL is not making excess profits. CAA should review its approach to independent assurance of its decisions.
- Airlines consider strongly that NERL should not earn an allowed return on the revenue losses of 2020-22. The CAA should consider how the covid TRS debtor is actually financed.

### **Cost assessment**

- The CAA should only include efficient operating expenditure in price controls and provide appropriate incentives for NERL to become more efficient, in line with a competitive market environment. Allowances should only be made for fully evidenced and justified elements.
- CAA should have an active role before business plan submission and use external consultants and have appropriate resources to deliver on its duties. CAA should carry out its own assessment of costs in a transparent manner, rather than starting with NERL's initial business plan. There should be a sufficient level of detail and granularity in information in both NERL's engagement, business plan and the CAA's determinations.
- There should be sufficient incentives on NERL to improve cost efficiency and pass on these efficiencies to consumers.
- CAA should monitor and report on NERL's costs, including staff pay and pension costs, on at least an annual basis.
- CAA should assess drivers of opex growth and priorities on a bottom-up basis from an early stage to lead to efficient cost allowances for NERL's business plan. Earlier assessment would allow for more Constructive Engagement and airline input. NERL's estimates shall not be the starting point of CAA's efficiency assessment.
- CAA's consultants provided a reasonable assessment of pension costs.
- The use of consultants is welcomed but should take place earlier in the process.

### **Environmental sustainability**

- NERL's target for emissions reduction is less stretching than what is expected to be achieved by the UK aviation industry and compared with other ANSPs.

- CAA should make improvements to the 3Di metric and continue to support airspace modernisation.

## **WACC**

- Some concerns with the approach to estimate particular parameters of the WACC. While the NR23 WACC could be a starting point for NR28, it will need to be adapted given the unusual covid-19 context and emerging precedent. Updated market evidence should be looked at to assess if the return allowed is appropriate. Regulatory precedent is a useful starting point but need to consider changes in market data and the regulatory environment.
- CAA should take a long-term approach and exclude atypical events.
- The asset beta was not reflective of the risk to NERL. The betas for the chosen comparator group should be reviewed as those comparators have activities that are not comparable to HAL and NERL, such as non-European airport operations. There is a risk that the asset beta at NR23 over-estimated the actual business risk that NERL bears.
- Request for a further technical discussion on the RAB and WACC.