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Sent by email to economicregulation@caa.co.uk

IATA Response – Guidance for NERL in preparing its business plan for Reference Period 3: consultation document (CAP 1593)

Dear Ms Fraser,

The International Air Transport Association (IATA) welcomes the opportunity to respond to the UK CAA's consultation document on the guidance for NATS (En-Route) Limited (NERL) in preparing its business plan for Reference Period 3 (RP3).

Please find attached our responses to the questions posed by the CAA as part of the consultation document CAP 1593. Additionally, I am providing for CAA consideration the IATA position paper on the evolution of the Performance and Charging Scheme for RP3.

Should you require any further input or clarification by IATA regarding RP3, we would be most pleased to assist.

Kind regards,

A handwritten signature in blue ink, appearing to be "P. Curran".

Mr. Peter Curran
Safety & Flight Operations
Europe
IATA

CAP 1593 Consultation Questions

Proposed high level approach to RP3 business plan guidance for NERL

Q1. Do stakeholders consider that a two track approach to NERL's business plan is reasonable?

- It is reasonable to ask NERL to provide an initial business plan that includes their thoughts on what they consider “core” requirements, and then a range of more discrete “wider” initiatives. This approach should enable meaningful consultation on real choices that can be made when considering what the performance plan for RP3 should eventually include. In RP2 the initial choices were presented in terms of a service-led plan or a price-led plan, it is hoped that, given guidance to prepare a two track initial business plan, NERL will take into account airspace user (and other stakeholder) requirements, and consider cost and benefits from a user perspective.
- The guidance should focus NERL on developing an initial business plan for which they feel a high level of “ownership”.
- Any business plan must embed within the “core” requirement that all RP3 performance targets will be achieved.
- It is essential that NERL provide, as part of the business plan, detailed cost-benefit analysis to justify all major investments.

Draft guidance to NERL on outcomes and outputs

Q2. Do stakeholders have views on the allocation of activities and outputs between the core and wider categories for NERL's business plan?

- The proposed approach to capacity planning would be further improved over the existing arrangements if enhanced consultation mechanisms between stakeholders and Statfor would be implemented, thus supporting application of the Statfor base case scenario as the basis for all en-route charging zones.
- Increased granularity of the traffic forecast for the London Approach Service, is supported and should be the subject of specific consultation and agreement with airspace users.
- Technical and operational resilience measures must be explicitly justified by comprehensive analysis to support the value for money.
- IATA fully supports the identification of LAMP2 as a core requirement.

- IATA proposes a conditional price cap arrangement for RP3 in which the capex will be subject to a specific approval and recovery mechanism. The price cap would be adjusted at n+1 for the first year and at n+2 for following years of the reference period to reflect the inclusion of costs related to depreciation and interest for approved investments. Differences between actual and planned capital-related costs will be returned to or borne by airspace users at n+2.
- The proposed approach of IATA to manage capex as a conditional price cap will support those instances where there is uncertainty as to whether a technology should be adopted as part of NERL's licensed monopoly business, by allowing greater flexibility during the reference period.

Q3. Are there any further views from stakeholders on extending the scope of the incentives on NERL to put greater emphasis on resilience and noise?

- Any performance plan must ensure the necessary resources to achieve the network, national and/or local performance targets. Therefore, it is inappropriate for any incentive scheme to include a bonus.
- A transparent and fair process of penalties should be established to incentivize achievement of performance targets.
- IATA considers that NERL should not be incentivized to address noise via the EU Performance and Charging Scheme for RP3.

Draft guidance to NERL on the efficient costs necessary to deliver the outcomes and outputs

Q4. 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?

- Until airspace users see what third party assurance NERL provide, and the quality (in terms of applicability and level of detail) of that assurance, it is difficult to say if there is any additional assurance that NERL could reasonably provide.
- The CAA states various requirements for NERL in this respect that provide reassurance to airspace users that what NERL present should be credible; such as:
 - benchmarking
 - clear and compelling cost benefit analyses and strategic options
 - transparency of costs
 - improved visibility and granularity of benefits
 - an appropriate level of evidence that its cost forecasts are efficient
- There is a concern that it will likely be difficult for NERL to benchmark itself effectively and objectively. If NERL have to commission external research there has to be a

question as to the degree of trust airspace users will have in the findings; however the concept of NERL having to internalise the concept of having to prove its own efficiency is a good one, and the debate that will ensue should prove useful in terms of coming to a conclusion on this key cost aspect of the eventual performance plan. It will be important to have the CAA appointed external consultancy report, judging both non-staff and staff opex (inc pensions) efficiency and capex when discussing this aspect of their initial business plan with NERL.

- In theory the requirements as set out seem like a good basis for consultation; with NERL being required to demonstrate efficiency on the core (minimum) requirements – and then establish a range of extra “wider” options – on which they will be required to demonstrate the appropriate cost/benefit. NERL have always previously stressed the interrelatedness of their projects – and so the degree to which any real choice on a “wider” initiative (project) can be offered remains to be seen. Whilst we have an expectation that this process will be complicated, it should have value.
- We have similar concerns about the CAA expectation that NERL will suggest, in relation to the capital expenditure, “whether better financial incentives, reporting requirements or licence conditions are required to help encourage capital efficiency.” Whilst we would expect NERL’s response here to be born from self-interest, as opposed to a true customer-centric perspective, the ensuing consultation debate will at least be interesting, and hopefully eventually establish clear positions in this regard for the CAA to eventually determine on as part of the performance plan and licence conditions.
- As already stated, IATA proposes a conditional price cap arrangement for RP3 in which the capex will be subject to a specific approval and recovery mechanism. The price cap would be adjusted at n+1 for the first year and at n+2 for following years of the reference period to reflect the inclusion of costs related to depreciation and interest for approved investments. Differences between actual and planned capital-related costs will be returned to or borne by airspace users at n+2.
- Only those investments identified within the investment plan, consulted with the airspace user community and approved, should be made. Where unapproved investments are made, costs related to depreciation and interest should not be eligible for inclusion in the unit rate.

Q5. 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?

- NERL should, as part of the business plan set out a template of measures on which it proposes to report its performance to customers over the course of RP3. The template should be granular enough to make clear NERL’s intent in relation to reporting RP3 KPI’s and PI’s and also the supporting aspects of operational, technical and people planning.

Q6. 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?

- The draft business plan guidance on capital programmes encourages NERL to consider governance arrangements. IATA takes the view that the existing governance arrangements do not properly permit the airspace users to proactively guide the setting of investment priorities for NERL. Additional guidance should therefore be provided to NERL, requiring that revised governance arrangement with a more leading role for airspace users, be proposed.

Q7. 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?

- The FFF arrangements should be addressed by NERL's broader revision of governance related to capital investment, but we have no objections to the FFF continuing under and within the appropriate processes and structure.

Q8. Should we provide further business plan guidance on expenditure governance arrangements and/or incentives?

- The draft business plan guidance on capital programmes encourages NERL to consider governance arrangements. IATA takes the view that the existing governance arrangements do not properly permit the airspace users to proactively guide the setting of investment priorities for NERL. Additional guidance should therefore be provided to NERL, requiring that revised governance arrangements with a more prominent role for airspace users, being proposed.

Q9. Is the draft guidance set out above on pensions reasonable and can it be improved?

- In regards to the pension costs the CAA has laid out a good level of detail about what is expected:
 - provide sufficient certainty to Trustees so that they support a reasonable profile of pension deficit repair costs
 - NERL demonstrating that it has done all it can to mitigate the burden on airspace users arising from the company's pension obligations
 - that NERL 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
 - 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
 - identifying cash costs of the DB Scheme separately from those of the DC Scheme, that the cash costs of the DB Scheme are separated between ongoing service and deficit repair

- assumptions supporting the December 2017 actuarial valuation are reasonable and are supported by independent benchmarking against other pension schemes
- The guidance may benefit from a clearer explanation of the CAA's expectations and logic in regards to how and why there would be a differentiation between some of the costs of pensions deficit repair for future service between core and wider costs.
- We look forward to being presented with details of how NERL has balanced the costs of increased pay remuneration in exchange for their employees foregoing rights to future pension service, and how this impacts on the cost of deficit repair and overall pensions costs.

Draft guidance to NERL on demonstrating financeability

Q10. Is the draft business plan guidance on the cost of capital, regulatory depreciation and financeability appropriate?

- *Cost of Capital* – The CAA proposes to take an approach that allows NERL to propose the cost of capital, allowing NERL to propose and justify the efficient level. In asking NERL to do this work that should not mean that the CAA are not also concurrently doing their own internal work to inform their own view of the appropriate cost of capital. Whilst the CAA's own view on the cost of capital for the HAL H7 price control review can be used to inform this debate there should also be separate work done to apply this to the environment NERL operates in. Whilst the RP3 process may start from a position of NERL taking the lead on defining its own business plan proposals, the CAA cannot let the regulated monopoly lead throughout the process. IATA expects the CAA to develop their own views on cost of capital independent of NERL.
- *RAB and regulatory depreciation* – IATA will engage with NERL and the CAA on development of new policy on regulatory depreciation if required. In the first instance NERL will need to demonstrate the impact of lower levels of depreciation on efficient financing.
- *Financeability* – In addition to the evidence the CAA has specified, IATA would want NERL to demonstrate how it manages its investor portfolio and what opportunities it has identified for more efficient financing.

Proposed approach to customer consultation

Q11. How should we best include airports in the scope of the Customer Consultation mandate?

- IATA would support airports being a consultee as part of the RP3 consultation process but we would disagree that they should be given equal weight to airlines in the process. Airlines pay user charges to NERL based on their use of airspace. Airports do not pay

any airspace user charges therefore they are not subject to NERL's monopoly and so do not have the same level of exposure to all of NERL's activities.

- IATA disagrees with any proposal that airports should be given the same key consultee status as airlines. In particular we see RP3 as being a tripartite process between NERL, the airline community and the CAA. A clear airline community voice is needed within the RP3 consultation process and including airports in the definition of customer, when they have their own objectives and drivers, would compromise this. Airlines are customers of NERL, airports are not. IATA would encourage the CAA to reconsider their proposals in this area.
- Whilst airports may be impacted by airspace modernisation, that activity is only one part of NERL's activities. When airspace modernisation goes ahead NATS will need to consult with airports as part of the airspace change process which is the more appropriate primary forum for NATS and airport engagement.
- IATA would support a specific form of consultation including relevant airports, NERL and the airline community to address matters such as capacity targets at certain airports. It is envisaged that such a specific consultation would be supplementary to the NERL consultation and may assist the CAA in addressing certain broader aspects of the UK RP3 Performance Plan.

Q12. What steps should NERL take to reflect the views of wider stakeholders, such as passengers and overflown communities, in the development of its business plan?

- IATA believes that within the NERL regulatory process, the airline community can best represent the passenger. The incentives airlines face in optimising capacity, reducing delay, and controlling and potentially reducing prices, strongly correlate with the passenger's interests. As in previous regulatory periods IATA and our airline members would share our knowledge of our passengers with NERL to assist development of the RP3 business. Ultimately we would contend that delivery of LAMP2 and airspace modernisation would meet the expectations of passengers more than any other initiative in RP3.
- The UK Government's new airspace policy and the new CAA airspace change process are focused on the impacts of noise on communities and will cover ongoing noise management and the impacts of airspace changes. Ultimately any RP3 project that leads to a change in airspace usage or an airspace change will be subject to community consultation and that is the most appropriate place for that consultation to take place.

Q13. 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?

- IATA would support taking the same approach as used in RP2 with a structured engagement programme based around the both the key components of the regulatory settlement and using the CAA's consultancy studies to inform and lead the process. The

customer consultation working group and the joint chair process worked well during the RP2 consultation and we would be supportive of following that model again.

- In addition IATA would be supportive of the CAA Independent Reviewer (IR) function that has been deployed in the RP2 SIP process also being used in the RP3 consultation process. The IR has built up a good working knowledge of the NERL RP2 business and an understanding of the business plan assumptions that relate to ongoing programmes extending into RP3. The RP3 consultation process would clearly benefit from making use of both the IR's knowledge and their expertise and it would be useful to further develop this and have access to that during the process.

Q14. What topics should the customer consultation programme address and what improvements can be made compared to the process for RP2?

- The topics covered in the RP2 consultation largely hold for the RP3 consultation process such as key priorities of airspace users for the RP3 period, NERL's proposed business plan, key components of the business plan etc. The RP2 consultation proposed a spectrum of business plan outcomes with a service quality-led and price-led plan at either end. Our expectation of the broad approach set out by the CAA for RP3 is that rather than follow a similar approach this time, the onus will be on NERL to propose their initial plan and then the process to achieve a revised plan will incorporate users views on service quality and price among other drivers. As such having specific topics on potential service quality / price trade-offs will not be necessary as it should be embedded in the business plan options NERL present to users throughout the process.
- IATA considers the primary objective in RP3 is to successfully deliver LAMP2 following its removal from the RP2 plan. Airspace modernisation will deliver more benefits for capacity, performance, delay, resilience, noise, and flight efficiency than any other measures that maybe delivered in RP3. IATA fully agrees with the CAA's position that LAMP2 should form a core requirement for NERL in RP3.
- Notwithstanding this position, it is also clear that although NATS should lead on driving LAMP2 forward to delivery, it is not wholly within their gift to deliver it. Recognising that change may happen in RP3, IATA believes that there needs to be a debate about how such change, if it happens, is dealt with and what mechanisms should be put in place to manage it and ensure airspace users have real choices. Managing the business plan within the RP3 period needs to be discussed as part of the consultation process.
- Areas of the business plan that may be impacted by Brexit should be clearly identified within the RP3 consultation process and information shared as and when arrangements for the UK's exit and transition out of the EU become known.

Q15. 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.

- IATA does not believe that there are alternative models of consultation that would significantly improve the process. The proposed process, as used for RP2, should drive effective engagement providing key inputs such as consultancy studies and the initial business plan are delivered to plan, and the CAA is able to hold parties to account and take an active role where necessary beyond simply being an arbiter between NERL and the airlines. The co-chair process allows for areas of difference to be identified, jointly worked upon, and for alternative proposals to be made. It also facilitates clarity in detailing the respective positions of NERL and the airlines which makes the CAA's job easier in understanding key issues to be addressed.
- During 2019, when the CAA consults upon the draft RP3 performance plan and up to the start of RP3, IATA does expect there to be an opportunity to update the plan in light of any potential UK-EU Brexit arrangements that have a material impact on the proposed business plan. We would consider that a mechanism - including customer consultation in an appropriate format for the stage of the RP3 development process – is developed to facilitate this.

Q16. 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?

- Consultancy studies should be made available to stakeholders prior to the start of the RP3 consultation process, or in the early stages of the process. They must have been made available in good time prior to any specific customer consultation that takes place on those topics. In RP2 some of the consultancy studies were released very late and after the process had finished – ultimately this negatively impacted the intention to ensure meaningful consultation. This should be avoided in the RP3 process.