

NERL response to CAA consultation, CAP2618 Setting future price controls – review of approach

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NATS

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1. Summary

NERL welcomes the fact that the CAA is seeking to identify opportunities to improve the efficiency, timeliness and effectiveness of the processes and outcomes of its price control reviews. These are important processes for the regulated companies, their immediate customers, for the travelling public and others reliant on air transport. They also have the potential to play an increasing role in enabling the aviation sector to transition to net zero carbon emissions in the coming decades.

As a public body, funded by the aviation sector, it is right that the CAA seeks timely feedback on its performance with the aim of working towards continued improvement in effectiveness and efficiency. The CAA should challenge itself to design and deliver a plan efficiently for each price control that makes best use of the limited time and other resources available to all stakeholders, sufficient to deliver a robust and coherent decision on the important issues for airspace users. We note that the CAA is also accountable to its sponsor, the Department for Transport (DfT), for reviewing the process, governance and mechanics of economic regulation, and that the DfT itself may then commission a wider review of the basis, scale and scope of all the CAA's economic regulatory activity.

We are concerned that the CAA is now, as it takes the first steps towards the next price control review, at risk of creating a process which stimulates considerable activity, consuming stakeholder time and regulatory capacity, but without the necessary focus on the key issues. The CAA's questions encompass a few fundamental issues and many more which do not need to be addressed now. We suggest more attention on the most important questions of scope and timing before setting in train the next review. We highlight these concerns regarding prioritisation and focus in our responses to specific questions.

Our summary response to the CAA's consultation is:

1. The economic regulatory framework for NERL has been demonstrated to be sufficiently robust and flexible to enable the company to weather the worst shock in modern times, while retaining access to private capital markets and maintaining appropriate controls and financial incentives to deliver a safe, resilient and cost-effective service. NERL's relative performance compares consistently favourably against its leading European air navigation service provider counterparts. Against that backdrop, there is no compelling case for significant change in the regulatory framework in order to close some perceived performance gap. There is a value to regulatory stability which would both support future investment in the business, and enable management to focus on outcomes delivering operational service improvements, technology upgrades and airspace changes for the benefit of users. This is a well-recognised principle of regulation as noted in the evidence of the UK Regulators' Network to the House of Lords Industry and Regulators Committee¹.
2. The CAA should focus at this early juncture on mapping out a much clearer proposal on the scope, process and timetable for the next review, before attempting to tackle any specific substantive issues. Given the very short time allowed by the CAA now to consider any of the

¹ UKRN response to call for evidence to House of Lords Industry and Regulators Committee 8 December 2023

latter topics, well in advance of any of the necessary preparatory work which NERL undertakes in order to engage effectively with a price control review, our responses at this stage are necessarily high level, provisional and subject to update and revision later. We do not address all of the CAA's questions on 'key price control issues' - where we have not formed a view yet, the absence of a response should not be taken to imply that we do not have strong views which will be expressed at a later date. We suggest that the CAA does not draw any conclusions prematurely from this first consultation exercise, but rather uses the responses to inform a clearer plan for future work in preparation for the next review.

3. The CAA should develop a robust plan to deliver a final price control decision by the final quarter of 2027 at the latest for the NR28 period starting January 2028. This should build on the positive developments from the NR23 review, notably the condensed period for production of NERL's regulatory business plan, which has driven more efficiency in NERL's approach to the price review, while avoiding overly prolonged periods for CAA assessment and decision-making. It should also allow for more deliberative constructive engagement between NERL and its customers on a focused agenda of the most important issues, which could inform the content of NERL's draft regulatory business plan. More joint working by NERL and airlines in advance could generate evidence and potentially consensus in some areas, thereby reducing the CAA's own workload. The CAA might also make more use of the existing mechanisms it has already put in place to support NERL-airlines engagement, such as the frequent dialogue on the Service and Investment Plan. Finally, the CAA could cope with workload peaks through more carefully managed use of external consultancy support, and become more agile in its decision-making, for example through delegating final approval of regulatory statements to board sub-committees.
4. There are a few key topics which deserve some greater consideration by CAA before the start of the formal price control review. In NERL's view, these are:
 - New airspace users – how services provided by NERL to support safe flight by uncrewed and other new airspace users in integrated airspace, funded from charges on such users, might best be regulated given the particular market structure, distinct from existing en route services.
 - Aviation's transition to net zero carbon emissions – how the regulatory framework for NERL might be adapted to encourage the appropriate focus of operations and investment on this wider public policy goal, and take account of the impact of climate policies on demand for aviation.

2. Process, governance and key price control issues

2.1. The process for setting price controls

2.1.1. Market power

The CAA notes that the Transport Act 2000 does not provide for market power determinations in relation to NERL. The provision of en route air traffic services by NERL is assumed to be a monopoly activity where ongoing regulation and price control will be necessary. The CAA concludes that:

“Lessons learnt: our existing approach to dealing with the risk of abuse of substantial market power by HAL and NERL is reasonable, through economic regulation and licences.”

Response

We agree with the CAA’s conclusion in respect of NERL’s current en route services (UKATS and Oceanic). There are, though, other services which NERL is planning to deliver to support integrated traffic management which would enable crewed and uncrewed aircraft to operate safely in the same airspace. We envisage that these services would be provided by a separately regulated part of NERL (termed NATS OpenAir), with its own segregated cost base and its own charges to recover those costs directly from Air Navigation Service Providers (ANSPs) which in turn provide services to uncrewed aircraft. This could form a third ‘single till’ within NERL’s economic regulatory model, under which the form of regulation for each of UKATS, Oceanic and new airspace user services could be set specifically in light of the structure of the relevant market.

We are currently consulting with industry on the scope and design of the services which NATS OpenAir might provide initially, and how it might be regulated to protect users’ interests. As part of this, we are proposing that NERL (via NATS OpenAir) would be the UK national provider of a new defined set of data integration and exchange services, which ANSPs serving integrated airspace would be required (via safety regulations) to take from NATS OpenAir. This safety regulatory requirement for a single provider of data exchange and integration would create a position of monopoly power, which would warrant some form of economic regulation to protect users’ interests. We are currently consulting on what type of regulation might be best suited to this emerging market, and are proposing a less intrusive approach, commensurate with the more limited costs involved, than the cost-based price control applying to en route services.

2.1.2. Objectives

The CAA notes that it will consider defining specific objectives for either or both of the upcoming HAL and NERL price controls. These objectives would complement and be fully aligned with its statutory duties and could be useful if there are any specific factors that will be especially important for forthcoming reviews. The CAA concludes that:

“Lessons learnt: the use of key policy objectives can help in providing a clear focus for the work of the price control review.”

Response

We recognise the potential for a well-framed policy objective to focus the work of a price control review, so that updated regulation can incentivise the regulated company to respond to major

challenges. Where a regulated sector is facing a major strategic external challenge (as in the de-carbonising of the energy supply sector) or a significant loss of public confidence in its performance (as in the water sector), then a policy objective to respond to these defined challenges can help to prioritise the price review. In NERL's case, there is a range of important issues in which NERL will need to invest in the coming decade which could form the basis of a CAA policy objective for the NR28 review. These include delivering the Airspace Modernisation Strategy, to secure more efficient flights and the safe integration of new airspace users, and maximising NERL's contribution to the Government's aviation net zero goal.

In setting any explicit policy objectives, we would encourage the CAA also to weigh up the benefit to users from continuity of regulatory practice. Stable regulation, enabling focus on outcomes, would be best supported through a greater understanding by the CAA of the interaction between areas within the price control mechanism, incentives and other externalities. The subsequent ability to take a holistic view of outcomes in conjunction together with users is more likely to lead to a robust outcome. In this case, the addition of policy objectives which are separate to but entirely consistent with the CAA's statutory duties would need to be positioned carefully to avoid confusing stakeholders and adding to the regulatory process without resulting in any materially different outcomes.

The concept of policy objectives begs the question of who sets the policy, and on what authority. Under the Transport Act 2000, there is scope for the Secretary of State to provide "guidance on environmental objectives", of which the CAA must take account alongside its other secondary duties to users' interests, etc, behind its primary duty to safety. Were the Government to provide such guidance to the CAA in advance of the NR28 price control review, this could provide a locus for the CAA to set a policy objective to respond effectively to this guidance.

Without such explicit guidance, it may be difficult for the CAA to give any weight to environmental factors in reaching its price control decisions, except to the extent that these are supported and articulated by users. This is notwithstanding the broader UK policy context in which the Government is bound by legislation to transition the UK economy to net zero carbon, under the Climate Change Act 2008, and the Government's sector-specific Jet Zero strategy, setting out a framework and plan for achieving net zero aviation by 2050. This apparent disconnect between public policy towards net zero in the economy as a whole and aviation in particular, and the objectives of the CAA in economically regulating NERL (as expressed through its statutory duties and guidance from the Government), may hinder the evolution of NERL's regulatory framework so that it can better support transition to net zero in aviation. We suggest that the CAA prepare as a matter of urgency to engage on this topic with the Government following the upcoming UK General Election.

2.1.3. Proportionate and transparent regulation

The CAA notes that the RP3 and NR23 reviews have highlighted the complexity of the price control framework, which has in part arisen from the responses to wider trends in aviation (airspace modernisation, new airspace users) and to economic shocks delivered by the pandemic. The CAA concludes that:

"Lessons learnt: for NERL in particular we should look at opportunities to simplify the regulatory framework."

Response

We accept that some aspects of the regulatory framework entail some complexity in their implementation and explanation to stakeholders. We agree that it is a matter of good regulatory practice to review periodically the controls and adjustment factors in place under NERL's licence and to test whether their objectives could be more simply realised. We note though that the underlying purpose of many of these measures remains valid, and that simplification options

should be considered carefully on a case-by-case basis: simplification should not be a guiding principle for conducting the next price control review. As an example, the adjustment of determined costs, allowed revenues and charges over time, in light of actual rather than forecast data, is an integral part of the framework which serves overall to reduce the financial risk which NERL faces. This in turn enables cost efficient financing, to the benefit of users, while retaining clear incentives on NERL to manage a safe and resilient service which delivers outcomes for users in a cost-efficient manner. We would be concerned if any drive to simplify the operation of the RAB led to the removal of these mechanisms, which provide an *ex post* “true up” – this could, incrementally, increase financial risk on NERL without delivering any user benefit.

In our view, the regulatory framework currently in place does not unduly impinge upon the ability of NERL’s board and management to run the business to deliver and develop a safe resilient service for users. This should be a test when considering whether to simplify any aspect of the current framework, or whether to introduce any additional complexity.

The complexities which the CAA highlights (essentially, adjusting charges for actual data within each price control period) could perhaps be explained more clearly to users. They do need to be implemented robustly via a price control financial model. We have been actively engaging with the CAA through the NR23 review to assist in the development of the CAA’s financial model, and are willing to continue to assist in preparation for the next review. A better functioning financial model would enable the more efficient translation of regulatory policy towards *ex post* true ups into data for price review documents and ultimately licence conditions and charges.

2.1.4. Constructive engagement

The CAA is considering how well constructive engagement has worked and whether there are opportunities to refine the scope, nature or timing of the process to improve its effectiveness at future price control reviews. It concludes that:

“Lessons learnt: constructive engagement continues to be an important part of the process for setting price controls in the aviation sector.”

Response

We agree with the CAA’s conclusion and its focus on seeking to enhance the effectiveness of constructive engagement. Given the exceptional circumstances of the NR23 review, the period for constructive engagement (via the Customer Consultation Working Group) was necessarily compressed between mid-summer and December 2022. Nevertheless, NERL was able to conduct a comprehensive engagement on an outline business plan issued in September 2022, via a series of structured workshops and parallel online presentation of material, capture of airlines’ feedback and response to their questions. We recognise the pressures that this compressed timetable placed on airline participants to consider and respond to material presented by NERL, and noted that airlines considered that the consultation could have been better supported by a fuller and more detailed initial business plan from NERL.

We suggest that for the NR28 review, the CAA structure the timetable to allow more time for NERL-airline constructive engagement to inform the production of the initial regulatory business plan and to take airline feedback on that. This could build on the dialogue which takes place on a regular basis through different forums, such as the Service and Investment Plan consultation process, and the Operational Performance Agreement. The CAA could also helpfully set the agenda for constructive engagement on those topics where NERL-airline consultation might be most productive (such as traffic forecasts and their implications for service outcomes, investment priorities and the reporting of progress on investment delivery). This should also delimit discussion on issues better left to CAA scrutiny, such as assessing cost efficiency and setting determined cost allowances, and determining the allowed cost of capital. Finally, a longer

initial engagement period could allow for more considered views of others, such as passengers' interests (as understood through research) and any relevant government guidance.

We envisage three distinct phases of the next price control review:

- i. Early high-level bilateral engagement at executive level between NERL and its customers, to explore their respective views on the priorities for NERL to deliver in the coming 5-10 years. The outputs from this would inform NERL's production of its initial regulatory business plan.
- ii. Constructive engagement in a multilateral forum, including CAA participation, focusing on those CAA-specified topics where airline inputs could help improve NERL's proposals and potentially achieve alignment.
- iii. Scrutiny of NERL's submitted regulatory business plan by the CAA, taking into account views of users and inputs from the CAA's advisors and NERL's responses to requests for information.

2.1.5. Timetable

The CAA acknowledges that the timetable for NR23 was extended a number of times to allow time for CAA assessment, decision-making and document production, and that parallel running of the H7 and NR23 reviews was challenging. It recognises that there may be scope to make the process more robust, efficient and timely. It highlights that one option to reduce the amount of parallel running would be to start the NR28 review a year later and make final decisions on these matters in 2028, rather than 2027, with some true up mechanism. It concludes that:

"Lessons learnt: running the H7 and NR28 price control reviews in parallel put a significant strain on CAA resources, which contributed to the delays to the price control reviews."

Response

We observed that the CAA did seek to boost its own internal resources during the extended NR23 review period through bringing in external contractors and consultancy teams, in order to manage peak workloads. It appeared to us that these complementary additional resources were not fully planned for and factored into the NR23 workplan from the outset (as evidenced by upward revisions to the estimated costs as the review progressed). We suggest that a more deliberative approach to plan to bring in more external analytical resources, and to re-organise decision-making processes, could help in future to avoid unplanned delays.

We suggest that the CAA should develop a robust plan to deliver a final price control decision by the final quarter of 2027 for the NR28 period starting January 2028. This should build on the positive developments from the NR23 review, notably the condensed period for production of NERL's regulatory business plan, while avoiding overly prolonged periods for CAA assessment and decision-making. It should, as mentioned above, prioritise the agenda so that work can be completed by the CAA in the allotted time. It should also allow for more deliberative constructive engagement between NERL and its customers on a focused agenda of important issues, as noted above, which could inform the content of NERL's draft regulatory business plan. More joint working by NERL and airlines in advance could generate evidence and potentially consensus in some areas, thereby reducing the CAA's own workload. The CAA's own assessment of key regulatory 'building blocks' could be better focused on those issues of greatest materiality to customers. Finally, the CAA could manage workload through planning to bring in external consultancy and contractor support to cope with workload peaks. It could also aim to become more agile in its decision-making through delegating final approval of regulatory statements to board sub-committees.

2.2. Governance around price controls

2.2.1. Management of process

The CAA notes that it will review its approach to managing the price control review process to make sure it is effective and timely. As well as looking at CAA processes, it will consider the need for clearer and stronger expectations around timely submissions of information and responses to consultations from HAL, NERL and other stakeholders. The CAA concludes that:

“Lessons learnt: to support the timely delivery of our work programmes we should have a focused decision-making process and stronger expectations around the timely provision of information by licensees and stakeholders.”

Response

NERL strongly agrees that the price control review process can and should be improved to make it more timely and effective, while retaining important safeguards for stakeholders to allow adequate time for the consideration of regulatory proposals and to respond to requests for information. We welcome the CAA’s intent to examine how its decision making and stakeholder engagement processes might change to allow for more rapid processing of evidence into regulatory decisions and outputs, under the ultimate oversight of the CAA Board.

We are fully committed to playing our part to contribute to a timely and effective price control review by being clear in advance about realistic time required for key stages of the review (constructive engagement with customers, building the initial business plan, consultation with users and then refining the plan before submission). NERL contributed actively to the consultation in late 2020/early 2021 on the options for the timing and scope of NR23. Once the CAA had determined the major milestones for the review, though, NERL fully met its obligations to deliver its key submissions on the dates specified.

Following submission of its business plan in February 2022, NERL also responded in an agile and prompt manner to a wide-ranging set of follow-up requests for information. We delivered our responses with a median response time of 6 working days. At several junctures during the review, we offered the CAA a more interactive exchange (rather than simply a written response to a written question) as a means to understand and respond better to questions arising. More use of such dialogue could help expedite the flow of information at the next review, as would greater organisation by the CAA of questions arising on business plan submission, and greater specificity in the questions and level of detail expected for the answers.

2.2.2. Engagement and taking account of stakeholder views

The CAA notes that it will review its approach to engaging with stakeholders during the price control process, including regulated companies, airline customers and consumers. It highlights specifically that it will also consider how best to ensure that it understands consumers’ views and make sure these are appropriately reflected in the business plans of regulated companies and its decisions on price controls. It concludes that:

“Lessons learnt: we should consider how to best engage with stakeholders during the price control review process and how we reflect consumer views.”

Response

We agree with the implications of the CAA’s questions here, that it was difficult to discern how evidence on consumers’ (passengers’) views had been systematically gathered and weighed up, and where they had been influential on price control decisions. Securing high quality information on consumers’ views of en route air traffic control services is inherently challenging, given the intangible nature of the service to passengers, aside from the principal delivery of safety. NERL

contributed some research results from its quantitative survey and qualitative and deliberative focus group work, which provided corroborating evidence, alongside airlines' views, in support of the key priorities set out in its NR23 business plan. It also provided some limited evidence on the question of 'affordability'.

The CAA has a range of resources to assess consumers' views and interests, including its Consumer Panel and its annual UK Aviation Consumer Survey. We suggest that the CAA's price control team articulates more clearly how and when it would draw on these resources during the price control review, and on what issues it would expect NERL to provide evidence of passengers' views.

2.2.3. Guidance and information gathering

The CAA highlights that there have been a number of issues around the quality and timeliness of information provided by stakeholders to support the price review process. To address this, the CAA highlights better guidance and also the potential role of its formal information gathering and related powers. The CAA concludes that:

"Lessons learnt: we should consider how to improve the quality of information that we receive from stakeholders during the price control review."

Response

The CAA is not specific as to which price review (H7 or NR23) or which stakeholders its concerns relate. As noted above, we consider that we did in the most part provide high quality and timely inputs, in accordance with our understanding of the CAA's requirements. We do acknowledge, though, that given the inherent complexities in our operational and investment plans, it is incumbent on us to ensure that we have explained ourselves effectively to customers and to the CAA – this was an important conclusion from our own NR23 lessons learnt exercise.

We accept there were challenges as a consequence of the need to revise the capex investment plan, which led the CAA to commission a separate review of NERL's NR23 capex. This found that as costs and timescales had changed, '...NERL's explanation of these factors is properly costed and justified, but some of these factors could have been better anticipated in earlier cost forecasts'.

We support the CAA's objective (timely and reliable information on which to make robust price control decisions), and consider that the CAA could take practical measures, short of using its information powers, to achieve it. We would welcome any steps by CAA to make its guidance more effective, by being clearer and less generic, for example by explaining why particular inputs are required, what hypothesis or question they would address, and what level of detail and scope is needed. We would also welcome timely feedback from CAA where it considers that our responses to requests for information have not met CAA requirements.

2.2.4. Expert advice and quality assurance

The CAA concludes that:

"Lessons learnt: the use of external consultants and advisors provides vital support to our price control reviews and we should consider how to make best use of these resources in the future.

Response

We consider that the CAA should plan more explicitly for the use of external consultants as either a complement to or substitute for its own resources. The former mode (as a complement) appeared, to NERL, to work well, where consultants were able to bring their expertise (which was not available within the CAA) to bear upon a specific and clearly defined question. The latter

(substitute) mode appeared to work less well, with a range of individuals brought in at various times during the review to bolster the internal CAA team. It may be that earlier engagement with a dedicated consultancy could provide CAA with more consistent support through the review, with the ability to flex up inputs when required to manage peak workflows and thereby avoid unplanned delays.

2.3. Approach to key price control issues and building blocks

Introduction

As noted in the summary section, we consider that detailed consideration of the price control building blocks is probably not appropriate or necessary at this stage of the process, but should rather be considered as a core part of the NR28 review itself. Nevertheless, we provide some initial comments now to the points raised by the CAA in this consultation.

2.3.1. Traffic forecasts

The CAA observes that, for NR23, traffic forecasts (in this case, flights in UK en route airspace) from external sources were more readily available and their use was broadly supported by stakeholders, by contrast with the position in the H7 review. The CAA draws no specific lesson for the NR28 review.

Response

The NR23 review was informed by the Competition & Markets Authority's decisions in the RP3 price control review, where it clearly supported the use of the Eurocontrol STATFOR forecast. With this context, alignment of all stakeholders around a single independent forecast was helpful in focusing attention in the NR23 review on other more contentious issues. This was facilitated by active engagement from NERL's traffic forecasting team with counterparts at Eurocontrol, so that the latter were fully briefed on UK-specific dimensions of air travel and were able to incorporate these fully in their own Europe-wide forecasts. Close communication also allowed NERL early access to Eurocontrol data (underlying their published forecast) which enabled production of an Oceanic forecast consistent with the Eurocontrol view of UK en route traffic. In future, we recommend that CAA analysts maintain close dialogue with Eurocontrol forecasters to understand the basis of their forecast for UK airspace.

We consider that it will be important to take explicit account of the potential impact on traffic of climate policies towards carbon pricing and sustainable aviation fuels, which could increase the cost to passengers and thus dampen demand. We note that NATS' own latest forecast (made in December 2023) starts to identify such demand impacts on traffic towards the end of the NR23 period. Currently, Eurocontrol's forecast does not factor in these policy effects explicitly.

New airspace user traffic is not currently incorporated in the Eurocontrol forecast for UK en route airspace. It is likely that for the NR28 review, NERL will have to produce a bespoke UK traffic forecast for such new users, in support of its regulatory business plan for its new user services, alongside plans to serve existing users.

These comments, and the CAA's introduction of this topic, are premised on the assumption that the price control model continues to calibrate NERL's revenue (within the bounds set by the Traffic Risk Share mechanism) to the actual level of traffic handled. There is a broader question which the CAA does not address here as to whether NERL's revenue should be so sensitive to a factor over which it has no influence and to which its cost base can respond to only a limited degree within a five-year regulatory period.

2.3.2. Service quality

The CAA observes that it will consider whether it can improve the incentives on NERL to provide appropriate levels of service quality to consumers, as well as how the CAA demonstrates that consumers are receiving value for money. It will consider any recommendations coming out of the independent review of the air traffic systems failure in August 2023. The CAA has also stated in its final decision for NR23 that there should be a wider review of how environmental performance is measured for future price controls. The CAA concludes that:

“Lessons learnt: there is scope to consider how to further improve the regulation of service quality for both HAL and NERL.”

Response

We agree that the measurement of NERL’s contribution to enabling less environmentally impacting flights should be thoroughly reviewed in preparation for NR28. This links to our observations above about the weight to which the CAA can give to environmental outcomes, given its statutory duties and the absence of any explicit government guidance. We suggest that this process should start as early as practicable and fully involve the CAA as our research evolves. We would welcome guidance from CAA on how best to achieve this collaborative process.

We suggest that in considering potential further improvements to regulation of service quality, the CAA should place that in context of what the regulatory regime has delivered to date. The CAA’s brief assessment and lessons learnt make no acknowledgement of the effectiveness of the current performance regime in the UK, which incentivises service delivery each year and cost efficiency over time. This stable regime has supported NERL to deliver consistently cost-effective services (weighing up both unit charges and the financial impact of delays), competitive with major European ANSP counterparts and demonstrating leading productivity scores².

We work for continuous improvement in our service performance, including through close engagement with our customers via the Operational Partnership Agreement multilateral meetings and bilateral dialogue with individual airlines. We recognise that the CAA will reasonably seek to challenge NERL at each price review to target further improvements. As highlighted in the NR23 review, we urge the CAA to consider explicitly and carefully the overall balance of regulation between quantified service targets and other aspects of performance, such as resilience. While parameters of service targets will be updated at each review, we note that stability of the regulatory framework has a positive benefit in and of itself – by contrast, change without clear justification can often come with costs which are not fully accounted for.

We note the reference to the independent review of the air traffic systems failure in August 2023, and will respond in due course to any recommendations emerging from that which pertain to the regulation of service quality.

2.3.3. Traffic risk sharing

The CAA notes that it will consider how traffic risk sharing arrangements should best evolve, and concludes that:

“Lessons learnt: traffic risk sharing arrangements can provide useful protections for both the regulated business and consumers.”

² <https://ansperformance.eu/economics/ace-overview/>

Response

We agree strongly with the CAA's lessons learnt in this area. The principle of the traffic risk sharing mechanism, that was upheld through the traffic shock arising from the pandemic and is now enshrined in the NR23 settlement and in regulatory policy for the subsequent period, was crucial to enable NERL to continue to obtain cost efficient private finance through this period. The NR23 review itself provides a valuable precedent for investors in understanding how the regulatory framework can adapt to cope with major shocks, within the existing legislation and without the need for government intervention. The NR23 review also delivered a material amendment to the traffic risk sharing (TRS) mechanism which should serve to make it more credible to rely upon the terms of the TRS in the licence, in the event of any material downside shock to traffic in future, rather than revise the terms of the TRS as was necessary for the 2020-22 period.

As noted elsewhere in this response, there is value in regulatory stability in this area, where there is no pressing stimulus for any substantial change. In this case particularly, change has already been delivered in NR23 and there looks to be no case for further revisiting the arrangements.

One issue for consideration at the next review, though, concerns the implementation of the TRS mechanism, and the traffic forecast on which the risk share is based. It is likely that the impact of policies aimed at reducing the carbon impact of aviation will start to impact upon the costs of flying and hence demand in the coming decade. The uncertainty about the scale and pace of impact, linked to uncertainties about the economics of sustainable aviation fuel supply and policy decisions, could add to the risk in the traffic forecast and potentially skew it towards the downside. We encourage the CAA to consider this aspect explicitly when deciding how best to implement the TRS mechanism.

In the longer term, there may be merit in revisiting the underlying premise of the price control model including the TRS, to examine whether NERL's revenue should vary to the current extent for traffic variation within +/- 10% of the central forecast. For example, if continual growth in aviation were no longer the base case assumption, as a result of climate mitigation policies, then the financial framework might be set differently. This might provide more opportunities to achieve financial returns through excellent service outcomes with less scope to gain or lose from windfall traffic variance versus forecast.

2.3.4. Cost assessment

The CAA notes that it will consider its overall approach to cost assessment, including how it reaches an independent view of costs, the balance of top-down and detailed assessments and different tools it should use. It concludes that:

“Lessons learnt: we should consider how best to improve our approach to cost assessment.

Response

We have no specific views at this stage on this topic, beyond the general observations that: (i) the CAA should motivate any change by a clearer identification of a shortfall in performance or outcome which might be remedied by any proposed new approach, and (ii) the CAA should be fully informed by latest practice adopted by other UK economic regulators, and any relevant findings from price control appeals to the Competition & Markets Authority.

2.3.5. Opex and capex incentives

The CAA notes that it will consider whether it can further strengthen incentives for efficiency and delivery, while not creating undue risks that would make the financing of capital investment more costly. Following its review of key capital programmes for NR23, it will consider mechanisms for

incentivising efficiency, delivery, and benefits in NERL's capex programme. The CAA concludes that:

"Lessons learnt: setting incentives for efficiency remains an important part of the price control review process."

Response

The high-level lesson learnt is a statement of fact, although implicit within that is an assumption that cost efficiency is a primary concern of airlines and passengers, with no acknowledgment of the value attached to resilience. Without exposing and exploring this dimension more explicitly, there is a risk that any drive by the CAA to "further strengthen incentives for efficiency and delivery" could distort the overall price control to the detriment of investment in resilient services and systems. We would encourage the CAA to view its work on cost efficiency within the wider context of securing a balanced settlement which incentivises NERL to deliver a set of outputs (safety, resilience, service performance) which are valued by users, and to do so reasonably efficiently.

Also inherent in the CAA's stated approach is a view that it is for the regulator to identify in advance the full scope of potential cost efficiencies which might be achievable by NERL in the coming five-year period, make estimates of savings which might be realised, and set the determined cost allowance and hence charges on that basis. This approach tends to lead to an ever more detailed scrutiny by the regulator, with rapidly diminishing marginal returns in terms of impact on users. An alternative is to conduct analysis at a higher level, focused on key cost items, and allow NERL to identify and drive out efficiencies within each regulatory period, from which customers benefit in the subsequent cycle when costs are reset.

2.3.6. Contributing to UK aviation reaching net zero

The CAA notes that the NR23 price control includes financial incentives on NERL to provide air traffic services in a way consistent with the provision of efficient flight paths. It concludes that:

"Lessons learnt: the existing price control framework provides a reasonable basis for allowing licensees to contribute towards the UK's legally binding target to reduce all greenhouse gas emissions to net zero."

Response

For the reasons set out above (Summary and 2.1.2 Objectives), we disagree with this assessment. We suggest that the CAA and the DfT jointly consider whether the CAA has a sufficient legal remit, whether via government guidance or updated duties, to make regulatory decisions which give appropriate weight to environmental objectives alongside users' interests. This should be undertaken as a matter of urgency to inform the next Government, and before the start of the next price review.

2.3.7. Inflation indexation

The CAA notes that the Government has set out plans to align the retail price index (RPI) with the consumer price index including owner occupiers' housing costs (CPIH) by 2030, and that there may be advantages to using CPI or CPIH indexation for prices, the RAB and the calculation of a real cost of capital for NR28. The CAA concludes that:

"Lessons learnt: we should consider how we treat inflation in setting price controls, including with respect to the indexation of the RAB and the cost of capital."

Response

We agree with the CAA's intention to move away from use of RPI as a measure of inflation towards use of one of the consumer price indices, provided that the transition is demonstrably neutral in net present value terms for users and NERL.

2.3.8. Cost of capital

The CAA observes that its approach to the cost of capital was broadly endorsed by the CMA in its consideration of appeals against the H7 decision, and that this would support continuity of approach at the next reviews. It also notes that its approach will need to be adapted and improved to keep pace with emerging precedent and changing market conditions. It concludes that:

“Lessons learnt: we should build on the CMA's assessment of our work on the cost of capital to inform our approach to these matters at future price reviews.”

Response

In NERL's view, it is too early in the process for the NR28 review to comment on this topic in a meaningful way.

2.3.9. RAB and depreciation

The CAA comments that there are a number of different incentive mechanisms where adjustments are made to the RAB rather than directly to revenues. In addition to considering the approach to depreciation, it will also consider whether there are opportunities to simplify the future price control framework and adjustments to the RAB. The CAA concludes that:

“Lessons learnt: we should consider the approach to regulatory depreciation and RAB adjustments to ensure that they remain consistent with our statutory duties and continue to support efficient investment.”

Response

As noted above, the primary purpose of the adjustments to the RAB and regulatory depreciation remains valid: helping to mitigate NERL's financial risk and thereby keep its costs of capital lower than otherwise, to the benefit of users. Within this category, though, there may be some specific measures which no longer provide any material benefit and could be simplified. We would caution against adopting 'simplification' as a goal of regulatory policy / approach.

2.3.10. Package of incentives, risk sharing arrangements

The CAA comments that incentives for efficiency and quality of service and risk sharing arrangements are key to creating a balanced approach to price controls. It concludes that:

“Lessons learnt: we should consider whether we should increase the focus and transparency we give to the overall package of incentives.”

Response

We agree with the CAA's lesson learnt. In our view, there was inadequate attention by the CAA to the impact of setting stretch targets across the board on the balance of resources across operations, training and development / deployment of airspace change and new technology. We accept that striking the right balance is a matter of judgement and can be difficult to prove empirically. Nevertheless, in our view, the CAA tended to consider each performance metric in isolation from others, and without adequate reference to the capacity of the business to meet a range of objectives in the NR23 period.

In addition to considering the suite of performance metrics and the level at which targets should be set, the CAA should also provide more transparent assessment of the risk placed on the business by its suite of financial incentives. For example, in NR23 NERL faces maximum penalties for service delivery totalling £65m (2024 prices) and for capex engagement £50m. This balance does not obviously align with what NERL understands airlines' priorities to be. The CAA could be more deliberative and consultative in considering where best to 'spend' the budget of financial risk it considers is appropriate to place on NERL.

2.3.11. Financeability

The CAA observes that for equity financeability, it has taken somewhat different approaches in the NR23 and H7 price controls and, in each, its approach has evolved over the course of the price control. It concludes that:

"Lessons learnt: we should consider further our approach to testing equity financeability."

Response

We agree with the CAA's lesson learnt. The approach taken by the CAA for NR23 caused assumptions around dividends to be a significant factor within equity financeability. We would welcome the opportunity to explore with the CAA ways of avoiding that for the NR28 review. In our view, it would be appropriate to give more consideration to the risk of equity return variability, and this should be linked to the greater focus on the overall package of incentives and the balance of risks within traffic forecasts and opex cost allowances.

We also consider that, given the wide range of potential causes for considerable downside traffic shocks, the CAA should undertake more comprehensive testing of a wide range of scenarios (rather than the single 10% traffic drop which was tested in the NR23 final decision-making). The CAA's statutory duty towards NERL's financeability should motivate this. To support this work, the CAA should invest in better functionality within its price control financial model to enable it to run scenarios more easily and reliably.

3. Broader strategic issues

3.1. Form of controls

The CAA notes that it does not plan to change the overall framework for NR28 of setting price controls based on a single-till RAB framework for a period of five years. Nevertheless, it could consider alternative treatments for specific costs or parts of the price control.

Response

As per our previous comments, we welcome the proposed overall stability for the form of controls. The one area which we currently identify as warranting some consideration before the next price review is the trend towards greater use of software as a service (SaaS), both in general business support functions and in more specific air traffic control contexts. Where functionality is provided by SaaS, the accounting treatment is predominantly that such expenditure be treated as opex. In constructing its regulatory business plan for NR28, NERL will have to form a view as to the balance of software functionality which is likely to be delivered by investments in software assets, and hence treated as capex, versus that delivered via SaaS, and treated as opex. To deliver our future ATM services, we are intending to use a technology platform that will incorporate a range of virtualised capabilities in lieu of the current range of integrated physical and software assets. Some of these virtualised capabilities managed through the platform are likely to be classified as SaaS which will need to be expensed rather than capitalised. This shift in approach is not only a shift for NERL but a shift for the wider ATM industry supply-chain. As a result, there will be inevitable uncertainty about the means of delivery of projects more than 5 years hence when the regulatory plan is submitted. The delivery method of such projects, selected through optioneering, is likely to evolve in line with market trends for these services. We suggest that, as a starting position, the CAA should examine how to enable an allowance for capex to be ‘converted’ within NR28 to an addition to the opex allowance, with consequential adjustments to charges, depreciation and the RAB.

3.2. Environmental sustainability

The CAA observes that its future price control framework needs to appropriately support NERL’s plans to transition to net zero, for example through business plan and service quality incentives.

Response

We welcome the CAA’s clear acknowledgement that the price control framework for NERL can and should be more supportive of NERL’s contribution to decarbonising aviation in the UK. This should include enabling NERL to invest in decarbonising its own ground-based infrastructure and moving towards a planned approach to purchasing carbon removals as part of its 2035 net zero and 2040 carbon negative objectives for its estate.

With regard to aircraft emissions, we already incentivised to deliver fuel-efficient flight paths and would welcome further work with the CAA to explore how the current 3Di metric might be developed and/or complemented.

There are other potential incentive mechanisms which could work directly on airlines’ own route planning decisions, notably route charges. In that context, we note that the European Council and Parliament recently reaching preliminary agreement on the reform of the Single European Sky regulation (known as SES2+), which includes as a key element of reform:

“Mandatory modulation of en route charges will be introduced to encourage airspace users to support improvements in climate and environmental performance, such as the use of the most fuel-efficient available routing or increased use of alternative clean propulsion technologies, after a cost-benefit analysis determines that such a modulation is feasible and presents an added value.”³

We would welcome engagement with the CAA and airlines to explore whether and if so how route charge modulation might practically contribute to the broad goal of reducing aviation’s carbon emissions.

We note that the CAA frames its work here as contributing to the CAA’s own environmental sustainability strategy - this states that:

“The CAA will focus its expertise and leadership in the following areas:

7. Using our powers and duties to take account of the impact on the environment in our regulation and oversight.”

As discussed previously in this response, we are concerned that the CAA at present does not have the appropriate suite of duties, informed by government guidance, to enable it to give any weight to environmental issues except insofar as they are fully aligned with current users’ interests. Where public policy is setting increasingly challenging measures on the aviation sector to de-carbonise, there is by definition bound to be divergence between public and commercial interests. Without a clearer remit and powers, the CAA risks remaining relatively impotent to influence climate outcomes from its economic regulation of UK air traffic control.

3.3. Airspace modernisation and new users

The CAA notes that it will consider the Airspace Modernisation Strategy’s Elements as they relate to Heathrow, NERL, and government policy in developing its approach to H8 and NR28 reviews. It will also need to ensure that it takes account of relevant outputs and outcomes from CAA, the Government and industry’s Future of Flight activities.

Response

We welcome the CAA’s commitments with regard to Airspace Modernisation and Future Flight. The economic regulation of NERL has evolved in recent years to encompass the creation, funding and oversight of the Airspace Change Organising Group (ACOG), alongside the continued investment by NERL in a range of strategic and tactical airspace changes in support of the Airspace Modernisation Strategy. As the means by which airspace changes are designed and delivered evolves, and the role of NERL within those changes, then the CAA should ensure that economic regulation should provide a framework to facilitate and incentivise delivery, and certainly not become any break on it.

With regard to Future Flight, NERL is currently developing proposals for new services supporting the safe and efficient integration of uncrewed aircraft into lower airspace alongside piloted vehicles. We would welcome continued interaction with CAA to help ensure that the economic regulation of these services is appropriately regulated. The aim should be to set the framework to encourage the necessary investment and risk-taking by NERL to stand up new services, while providing sufficient protection to users against any abuse of market power which NERL may have

³ European Council press release, 6 March 2024

by virtue of its central role as infrastructure provider for a range of ANSPs and data providers serving new users.

Other 'Broader Strategic Issues' highlighted by the CAA are specifically related to Heathrow⁴, and we do not offer comment on them.

⁴ Expansion at Heathrow airport, Provision and operation of new infrastructure at Heathrow airport, Scarcity rents, Charges and Airport Charges Regulations