NERL response to CAA consultation on RP3 interim price controls review (CAP 1994)

12 January 2021

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Overview

1 We welcome the opportunity to comment on the CAA's proposals about:

- the short- and long-term challenges faced in developing the regulatory framework for NERL;
- the policy options under consideration; and
- the timetable and processes for putting in place new price controls.

2 We appreciate the CAA's emphasis on **building on the current regulatory framework** to develop policy for the next price control (RP3i). With so much change arising from the pandemic, affecting the whole of the aviation sector, we consider that there is considerable value to users and NERL from the CAA providing continuity in its regulation of NERL. Changes should be by exception, justified primarily by the need to recalibrate the price control in light of latest evidence on the pace of recovery. Such stability can help us to plan efficiently, where our goals are to: 1) deliver the capacity needed to support the recovery; and 2) shape the longer-term investment programme to meet future demands of airlines. It also supports the efficient raising of finance, to the long-term benefit of users. Alterations to well-established regulatory practice, despite best intentions, could be costly to users in the medium term.

3 The CAA's approach will, as ever, be driven by its duties under the Transport Act 2000. We encourage the CAA to take a **broad and balanced interpretation of these duties**. Beyond the primary duty to provide the right conditions for NERL to deliver a high standard of safety in the provision of Air Traffic Service (ATS), the CAA summarises its objectives for RP3i in terms of "affordability" and "financeability". In fact, though, regulatory objectives are broader than this summary. The *Transport Act 2000* defines user interests as "the range, availability, continuity, cost and quality of air traffic services". We recognise the importance of ensuring that our charges are based on efficient costs and therefore are no higher than they need to be in any given year and over the price control period as a whole. We also recognise that <u>part</u> of the interests of users are served by NERL's charges being at a level that supports users in their recovery of their own services, given the difficult circumstances created by Covid-19. There are several mechanisms available to the CAA for achieving this, including spreading the recovery period for revenue losses from 2020 and 2021 across several years.

4 However, we caution that within a new five-year price control period beginning in 2022 or 2023, all currently available recovery scenarios predict that traffic levels will exceed 2019 levels again. With this return of traffic, the previous challenges of airspace congestion and delay will likely also re-emerge. Projecting forward the current understandable narrow focus on minimising costs across a longer time period could be a false economy, which would be regretted by all in the long term as it became superseded by other priorities for users relating to the range, availability, continuity and quality of Air Traffic Service. It is possible that this shift could happen half-way through the new price control period, or even earlier. For example, the CAA began investigating NERL for whether it had failed to meet demand less than half-way through RP2 in Spring 2017, where a key contributing factor was traffic growth higher than expected (across the UK as a whole but especially at Stansted and Luton airports). Therefore, we would encourage the CAA to assess "affordability" of ATS charges in the wider context of users' overall costs, and in turn to balance these concerns with wider user interests in NERL delivering a resilient service, including meeting

the developing needs for service and future capacity. It should also consider the impact of NERL's charges on ticket prices faced by passengers, the resulting demand for flights, and the extent to which this demand (which will drive the pace and scale of recovery in aviation) would be affected by the potential increases in charges which are in prospect.

5 The CAA will, as it clearly acknowledges, need to balance users' interests in affordability and other aspects with the **requirement to enable NERL to finance itself without undue difficulty**. The regulatory framework provides a range of protections to investors, which in turn are reflected in the efficient cost at which NERL can raise capital. We believe it is in the long-term interest of users that NERL can attract equity and debt finance on favourable terms. As the CAA acknowledges, changes in the risk-reward package from this price control review will need to be reflected in the cost of capital. This assessment will have to consider the impact of Covid-19 upon NERL, where the fall in demand has been orders of magnitude greater than that in other regulated businesses such as water, electricity and gas. We recognise that the scale of the economic shock from the pandemic is such that the parameters of the price control in general, alongside consideration of the revenue risk sharing mechanism, need to be reassessed, in accordance with the statutory framework. In doing so, we judge that it would be in users' long-term interests for the CAA to maintain, overall, a consistent balance of risk and reward for investors, as measured over the period from the start of the pandemic. The pandemic has revealed that NERL's business is more exposed to extraordinary demand risk than hitherto appreciated. This would need to be factored into a future reassessment of the cost of capital. It would be in users' interests to minimise any upward movement in costs of efficient capital, by mitigating any additional revenue risks to the extent possible through the design of the regulatory framework.

6 In particular, the adjustment of the revenue Traffic Risk Sharing (TRS) mechanism should be both temporary and tailored to deal with Covid-19 impacts specifically, which is the approach that has been adopted by the European Commission and National Supervisory Authorities for their European ANSPs. If investors perceive that the regulatory response to the pandemic stands outside this balance, there may be adverse consequences for investor appetite to fund further capacity improvements for users, and there may be adverse consequences for NERL's cost of capital that would increase prices for users in the longer term. Ultimately, NERL's cost of raising efficient capital would be impacted, which would raise costs to users. We support broadly basing TRS changes on those introduced by the European Commission, following consultation with stakeholders, for the Single European Sky Performance and Charging Regime. This would be one element of a balanced realignment that shares burdens between NERL and our customers. It would also mean that our customers do not face any extra burdens from misalignment in this aspect of ANS charging between the UK and the rest of Europe. We agree that such TRS modifications would need to be made to the Licence during 2021, for implementation by the start of 2022. This process could be separate from and in advance of the proposed broader RP3i price control review, although the latter should take into account the reconciliation of costs and revenues arising from the TRS modification.

7 In considering how best to reset the price control to achieve **"affordability" for users, while maintaining "financeability" of the regulated business,** we encourage the CAA to remain cognisant of the financing restraint shown by NERL's shareholders over the past two decades. NERL has adopted a prudent dividend distribution policy, despite the evident scope to do otherwise. NERL's relatively cautious approach has facilitated the reduction of NERL's gearing over that time, so that it entered 2020 with a strong balance sheet position. This in turn has helped it to manage the near term financial shock from the pandemic. Apart from making use of the general furlough scheme, NATS has not called upon Government for any additional support as a result of its shareholders'

historic prudence. NERL last declared dividends in November 2019 and is precluded by its recent financing from doing so in the near future. Beyond that, the prospect of future dividends is now uncertain. Consequences and risks at such a sustained level are, we believe, not representative of the expected returns most recently assessed by the CMA as being incorporated within the cost of capital. A careful regulatory approach to balancing the price control reset will ensure that our financial structure remains resilient through the medium term. Underpinning this is the significant contribution from shareholders, made through both the use of dividend-paying capacity to take on additional pandemic-related borrowing and in the form of dividends not declared despite the relatively low level of equity risk assumed within the current cost of capital assessment.

8 As part of the CAA's "affordability" assessment for resetting the RP3 price control, we also agree that there should be a reconciliation of all costs and revenues for the two years of 2020 and 2021. This reconciliation reflects the exceptional circumstances of Covid-19 and should be subject to an assessment of NERL's financeability.

9 The CAA identifies the need to modify temporarily the current **Traffic Risk Sharing (TRS) mechanism** in the Licence. This modification is to avoid the significant increase in charges which would otherwise occur from 2022, for deferred collections under the embedded n+2 mechanism in the Licence in relation to 2020 and 2021. We agree that in these one-off exceptional circumstances, a mechanistic application of the existing TRS rules would not be in the interests of our customers. There are however a number of options available to the CAA, including: 1) deferring the point at which revenues accruing from 2020 and 2021 due under the TRS start to be paid; and 2) extending the period of repayment.

10 We would welcome confirmation by the CAA in January 2021 of the principles that will underpin its approach to TRS, to support NERL's planned refinancing of its bank facilities during 2021 in as efficient a manner as possible.

11 The CAA has provided a draft **Regulatory Policy Statement relating to NERL defined benefit pension scheme costs**. While this has arrived later than hoped, we strongly support the intention of this statement and in very large part the contents. We do, however, have concerns about the additional requirement being placed on NERL and the pension trustees to demonstrate that the level of NERL's pension costs remain affordable, especially given the existing stewardship test requirements. We believe that affordability is more appropriately assessed by reference to the efficiency of NERL in delivering the forecast capacity, resilience and service levels which our customers require, which in turn is best judged in the context of NERL's overall business plan and its deliverables. As a policy principle for pension costs, we believe it is misplaced and risks undermining the value of the RPS generally. We suggest as an alternative that the RPS simply emphasises the existing duty on NERL and the Trustee towards effective stewardship, which could be expressed in the RPS as a requirement to demonstrate that pension costs remain efficient.

12 The CAA identifies two key options for the **timing of the next price controls**: 1) full price control review in 2021, leading to Licence modifications in place from January 2022 (2022 reset); 2) or full price control review over 2021 and 2022, leading to licence modifications in place from January 2023 (2023 reset).

13 We support the 2023 reset as being the most practicable option, combined with the TRS modifications by January 2022. We believe that it is in customers' interests for the next price control to be built on as firm an evidence base as possible. First and foremost, this requires an effective traffic forecast. Given the unprecedented level of upheaval within the sector, and never before seen impacts on traffic, resetting the price control earlier than this would result in a

significant risk of having to reset again, given that the trigger has been a 10% deviation in traffic actuals versus plan for NERL under SES (and a similar threshold exists for other regulated companies). We consider that attempting to undertake all of the stages of the price control review in 2021 for a 2022 reset, even if the review were very focused and all parties supported appropriately, would risk missing out on critical evidence about traffic and its consequences for our future operations and investment, to the detriment of NERL and our customers. We doubt also whether the timescale is in practice deliverable, leading to the risk that the process might have to be extended part way through, at the expense of wasted effort by all parties.

14 Given what we know now about the uncertain pace of economic and aviation recovery in 2021 and beyond, we judge that we could develop a regulatory business plan in Q4 of 2021, in light of much more information on the recovery, engaging customers in the evidence, options and implications for charges. Following customer consultation and refinement, we could deliver a regulatory business plan to the CAA by the second quarter of 2022. This timetable should allow for subsequent consideration by the CAA, consultation and then the statutory licence modification process. A 2023 reset still presents a very tight timetable, given the considerable uncertainties which are likely to surround the economic and sector recovery, and would only be feasible with a much more focused review than in the past. In addition, as recent events have shown, the extent of uncertainty around the development of the pandemic would need to be borne in mind.

15 In summary, we consider that the most effective outcome for our customers and NERL would be for charges to remain capped at the levels determined by the CMA until the end of 2022, and then reset as part of a new five year control from 2023. This could be achieved by modification to the Traffic Risk Sharing mechanism in 2021 (for the years 2020 and 2021), and in parallel a streamlined price control review over a window of up to 18 months in 2021 and into 2022, building on emerging evidence relating to the pace of recovery next year, but focusing on the most material aspects of the Licence which need to be recalibrated. This would defer any increase in UK regulated ANS charges arising from the pandemic to 2023, 12 months later than envisaged for the rest of Europe, giving our customers a clear affordability benefit as they build back their flying programmes.

1. Challenges for the review

16 This section responds to the issues raised in Chapter 1 of the CAA's consultation paper.

1.1. Responding to issues for 2020 and 2021

17 This section responds to the issues that relate specifically to the immediate impact on and recovery of the aviation sector from Covid-19 in 2020 and 2021.

1.1.1. Traffic risk-sharing

18 We agree with the CAA's assessment of the need to modify temporarily the Traffic Risk Sharing (TRS) mechanism for 2020 and 2021, to moderate the impact on charges which would otherwise come to pass from 2022 from deferred n+2 shortfall recoveries. Such modification should be based upon a balanced assessment of the CAA's statutory duties so that, in addition to the primary focus on safety, other longer term considerations such as NERL's financeability, its ability to invest both for the future and in a resilient service are also considered alongside shorter term considerations of customers' interests in affordable charges.

1.1.2. 2020/2021 reconciliation and review

19 We consider that the approach proposed by the CAA is pragmatic and proportionate overall, in focusing on the most important cost components and their variance. We largely support the proposals set out by the CAA in Appendix D.

20 In conducting the reconciliation exercise, we would encourage the CAA to recognise that we have taken timely decisions in the near term, in light of the best available information at that point, including, where relevant, feedback from customers[1]. We suggest that the CAA conduct its reconciliation review of 2020 and 2021 to recognise the difficulty of making financial decisions during this period, rather than versus an artificial *ex post* benchmark derived with the benefit of hindsight.

21 By way of context, we took early and decisive management action to secure continuity of our operations, preserve liquidity and minimise operating and capital costs. These actions were taken by NERL to maintain the safety of operations in the changed working environment (e.g. introducing Covid-secure rostering) and to protect liquidity, while sustaining our ability to deliver a high-quality service. We will continue to seek opportunities to save costs by continually reviewing evidence available on the recovery.

22 For calendar year 2020, NERL has delivered significant cash saving and conservation from our RP3 plan, driven by various management actions including pausing and then re-planning our capital investment programme, eliminating discretionary spend, freezing recruitment and drawing on the

[1] iSIP meeting with customers in June followed by detailed customer engagement sessions/workshops in September, October and November, and then the SIP meeting in December

Government furlough scheme. Some of the achieved savings are related to a timing change that benefited NERL's cash position for 2020, i.e. delaying payment or seeking advance payments. Such savings by their nature create a one-off relief. The remaining share translate to operational savings, most of which are also temporary in nature, enabled by the exceptional circumstances created by Covid-19, such as the Government furlough scheme.

23 We consulted with customers promptly when we suspended all but essential elements of our capital investment programme in Spring 2020 to preserve liquidity. We consulted with them again and sought their support for restarting the capital programme on a re-phased and segmentally controlled basis in Autumn 2020, after securing extra bank funding during Summer 2020. This consultation was supported by "deep dive" workshops to provide airlines with greater detail on our airspace and technology workstreams to facilitate their feedback. A further consultation was then held in December to bring together several options for NERL's investment programme based on this airline engagement, including the potential outcomes of each option and the associated timescales for delivery.

24 We, along with our airline customers and other aviation companies, have had to respond to a rapidly changing operational and financial environment. But our longer-term re-planning has been subject to greater constraints than other aviation companies, including our customers, given NERL's Licence obligations, our role as provider of critical national infrastructure, and the need to provide for a resilient service which can meet the needs of the aviation sector as demand recovers.

25 This latter requirement is further reinforced by the CAA's own draft findings in respect of its Palamon investigation, in which it recommends that NERL reconsiders its approach to staffing and technology and brings forward plans for a more efficient and resilient service.

26 In light of the above, we support the CAA's proposed approach of focusing on specific cost building blocks, as being proportionate, targeted, simple and transparent. We would aim to present evidence on key factors affecting the most important cost elements, including the rationale for changing some items and for maintaining others. There should be a fair or holistic treatment of short-term costs incurred to achieve longer-term savings that benefit all stakeholders. For example, to achieve longer-term, enduring staff cost savings to the benefit of airspace users through a voluntary redundancy programme, NERL has incurred upfront redundancy payment costs. We do not consider that a full regulatory business plan, justifying our overall costs by each line for 2020 and 2021, would be either necessary or proportionate for the CAA to reach a judgement on the efficient level of costs to be factored into a reconciliation exercise. It would also detract from our and our customers' attention on the important work of the sector's recovery and then re-planning for growth in the next price control period.

27 The CAA notes that the timing of the reconciliation review means that it will not be possible for NERL to provide data covering all of 2021 and so some (or all) will need to be on a forecast basis. It concludes that it would be necessary to revisit these forecasts and make any necessary adjustments as part of a future price control review.

28 We agree with this suggestion: the TRS modification should be based on efficiently incurred actual costs for 2020 and the first part of 2021, forecast costs for the latter part of 2021, with a mechanism for reconciling forecast to actuals for the whole of 2021, which would be reflected in the subsequent 5 year price control. If, as we argue for in section 3, the CAA were to reset charges for a new 5 year period from 2023, there would arise the question of what modification might be warranted to the application of the TRS mechanism for 2022, for example, if traffic in that year were more than 10% lower than forecast in the CMA Final Determination. In that situation, there

would be a case for adopting a similar approach of forecast costs and then reconciliation mechanism to account for 2022 actuals in the price control starting in 2023. This approach would, for example, allow for both the upfront costs and subsequent cost savings of NERL's voluntary redundancy programme to be reflected ultimately in user charges.

1.1.3. Financeability

29 We can best support the recovery of aviation activity in the UK if we are able to continue to finance our operations and investment efficiently to enable us to deliver a safe, resilient service, matched to the level of demand we face, and are able to invest with confidence in the longer term development of UK airspace. To that end, we strongly agree that enabling NERL to continue to finance its activities without undue difficulty will be a very important requirement for the CAA in responding to the near-term challenges created by the pandemic. This financeability consideration relates to both debt and equity capital, and so the regulatory framework should continue to enable NERL to attract both sources in an effective and efficient manner.

30 The context, as well set out by the CAA, is that the pandemic has severely affected airspace users, and has also significantly impacted NERL. This is was recognised by NERL, CAA and the CMA, and we agree with the CAA that for the affected years of 2020 and 2021 "[the CAA] cannot assume it will be appropriate to simply roll forward all the previous regulatory arrangements without modification".[2]

31 Throughout the pandemic, like many other businesses, NERL has been focused on the following critical, short-term objectives: safety (both operational and of its staff), liquidity and cost efficiency. The latter two are considered critical to ensure that NERL can play its part in making future charges for airspace users more affordable than they would otherwise be. On liquidity, we have responded very promptly to strengthen our short-term liquidity position through management actions and additional bank facilities. The dramatic reduction in traffic placed significant strain on NERL's pre-Covid liquidity and led the company to seek and secure a £380m additional liquidity facility in August 2020, supported by its existing commercial lenders and underpinned by an historic and prudent financing strategy which delivered low gearing. This demonstrated in practice the value of long-term support from shareholders retaining distributable reserves within the company.

32 This financing was achieved against a backdrop of uncertainty about the future regulatory framework for NERL. Over the summer, the EC issued draft proposals for how the existing traffic risk sharing mechanism might need to be amended, to assist airspace users with affordability issues in 2022 and subsequent years. In addition, Brexit added a complication for NERL's lenders in as much as it was not clear at that stage whether the CAA would either be required, or would elect, to follow the EC proposals, assuming they were passed into law.

33 In the absence of this clarity, significant reliance was placed on the financeability duties of the CAA and of the Department for Transport under the Transport Act 2000. This view was also expressed by NATS in its annual report and accounts: "we fully expect that the re-set will provide a balanced business plan which is aligned with our customers' priorities and flight schedules, taking account

[2] CAA 2020, *Economic regulation of NATS (En Route) plc: consultation on approach to the next price controls review: CAP 1994*, paragraph 10 of Summary

of the CMA's findings, the pre-existing commitment to traffic risk sharing and the financeability duties placed on the CAA under the Transport Act 2000."[3]

34 We require a refinancing in 2021, of bank facility arrangements totalling £780m that are due to expire in 2022. This would place our finances on a firm footing into the medium term. Achieving this outcome efficiently will require those lending to NERL to derive comfort from the extent to which the regulatory framework effectively limits NERL's risk exposure over the coming years. The TRS is a central part of the risk management function of the regulatory framework. The EC proposals now passed into EU law[4], represent a significant change in risk allocation. The new EU regulations provide airspace users with a large cashflow benefit, from delaying the recovery of revenue (by ANSPs) beginning in 2023 (instead of 2022) as well as spreading the recovery over five to seven years (instead of two). However, against this cash benefit, the EU process has the ambition of rebasing the traffic levels and resetting European ANSPs price controls in 2022, which is likely to push up their prices due to the much lower than planned traffic during RP3 so far, as well as the fixed nature of ANSP costs. The EU timetable requires Member States to submit their performance plans to the Commission by 1 October 2021, with ANSPs likely to have to submit their proposals before Summer 2021, which suggests that ANSPs' new business plans will be guided by Q1 2021 traffic levels.

35 Against this backdrop, we are seeking additional clarity from the CAA on any temporary revisions to the UK regulatory framework regarding the TRS. We are not seeking concrete or quantitative conclusions from CAA at this stage, as the detailed formulation of any adjustments would need to be finalised as we obtain greater confidence about traffic forecasts. In relation to NERL's request of the CAA, we consider that the comments made by the CAA in this consultation document should, once confirmed in the CAA's response to consultation, allow existing providers of finance to have confidence in the CAA's approach to NERL financeability. We welcome the extensive and specific acknowledgement and reference to these duties which are made throughout the consultation document CAP 1994.

36 In addition, we expect significant comfort will be drawn, for both existing and prospective providers of finance, from the comment that "…the approach taken by the European Commission provides a relevant reference point as EU Member States face similar challenges to the UK, to balance the interests of users and air navigation service providers (ANSPs)."[5]

37 The views formed by credit rating agencies will also be important in influencing the cost and terms on which we are able to raise new debt finance. Both credit rating agencies that rate NERL will inevitably look to issue updates to outlook upon the conclusion by the CAA of this consultation. Current pertinent comments from the agencies are noted below:

> Moody's: Moody's published an updated issuer comment because of the licence modifications arising from the CMA's final determination. In that document, Moody's referenced the EC proposals being approved by member states on 13 October 2020, and concluded that "while the

[3] NATS 2020, *NATS Holdings Limited Annual Report and Accounts Year ended 31 March 2020*, page 13
[4] European Commission 2020, *Commission Implementing Regulation (EU) 2020/1627 of 3 November 2020 on exceptional measures for the third reference period (2020-2024) of the single European sky performance and charging scheme due to the COVID-19 pandemic*
[5] CAA 2020, *CAP 1994*, paragraph 1.6

above conditions are unlikely to apply directly to NERL following Brexit, the CAA may ultimately decide to take a similar approach". (14 October 2020).

- Standard & Poor's: their comments follow a similar vein: "We expect NERL to recover the receivables in full as they are a legal obligation of the airlines. However, the airlines' ability to pay could affect the timeliness of the payments, which, under the regulation, are due two years after the charges are incurred. As there is no track record of recovery of receivables in these unprecedented circumstances for the aviation industry, we assume a more conservative scenario, under which NERL recovers the receivables in instalments in 2022-2026." (30 July 2020).

38 These comments suggest that were the CAA to conclude that an approach to traffic risk sharing for 2020 and 2021 that broadly aligns with that of the EU regulation was appropriate, such an approach would appear not to detract materially from NERL's ability to maintain a solid investment grade credit rating.

39 However, as part of the wider price control reset it would be necessary, as alluded to by the CAA, for appropriate incentives to remain within the regulatory framework. Equally, as part of the process of reaching a balanced settlement reflecting all its duties, the CAA should assess carefully how any deviations from the current regulatory mechanism might affect NERL's cost of capital and also the net present value impact of deferring the recovery of revenue. Clearly, such a regulatory assessment should consider not just aspects relevant to debt financing, but also the potential impact on the continued underpin and provision of equity capital on a sustainable basis.

40 Our expectation is that as part of the CAA's concluding statement in relation to CAP 1994, or indeed as part of a discrete statement on traffic risk sharing, the CAA states its position in relation to the following key principles and assumptions:

- Adjustments made to the existing regulatory mechanism will be considered in relation to the CAA's Transport Act 2000 duties and established regulatory policies with respect to NERL;
- The updated EU regulation is a relevant reference point for the UK's proposed modification of the traffic risk sharing mechanism;
- In proposing changes to the TRS, the CAA will assure itself that NERL's ability to finance its licensed activities would not be unduly affected by the revised arrangements, including any material deviation from the EU standard position; and
- The CAA will also assure itself that both the short-term and long-term impacts on customer affordability have been duly considered, noting that short-term affordability improvements to airlines could result in higher prices over the longer term (beyond the period of any recovery of TRS revenue accruing in 2020 and 2021) if there is a transfer of risk from airspace users to NERL.

41 We note that many of these are already referenced in CAP 1994 and look forward to them being confirmed in the CAA's statement of policy following this consultation.

42 The CAA goes on to say that: "NERL will need to actively support these broader aims, which may require support from wider stakeholders, including NERL's shareholders and pension trustees". We agree that NERL will support the recovery of the aviation sector by providing a safe, cost efficient and resilient service, aligned to the needs of our customers – we will provide evidence to the CAA that we are planning effectively and in consultation with users to deliver this outcome. The pension Trustee has its own responsibilities and accountabilities but can, on the basis of appropriate regulatory reassurance, make a significant contribution to NERL's cost efficiency goals (as

discussed further below). Shareholders have already provided substantial support through dividend restraint over the past decades, reducing gearing, enabling NERL to weather the immediate financial impact of the pandemic, with more dividend restraint shown during the pandemic and in prospect.

1.1.4. Regulatory Policy Statement on Pension Costs

43 We welcome CAA's intention to publish a regulatory policy statement (RPS) on pensions which will provide clarity to NERL and its pension Trustee on the long-term regulatory treatment of pension costs, including pension pass through. The RPS is especially pertinent as the Trustee undertakes a triennial valuation as at 31 December 2020, alongside the challenges of:

- significant uncertainty from Covid-19 and its impact on the aviation sector;
- the RP3 price control re-opener;
- the withdrawal of the UK from the EC's Single European Sky performance regime from 1 January 2021;
- financial market conditions for pension schemes; and
- the scale of the scheme's pension liabilities relative to NERL's regulatory asset base.

44 As we explained in our RP3 business plan document (October 2018), the financial strength of NERL determines the degree of prudence the Trustee adopts in the valuation of the scheme's liabilities and the level of risk that can be supported in the scheme's investment strategy. In assessing NERL's financial strength, Trustee perception of the risk of NERL not being able to meet its pension obligations is determined by confidence in the regulatory framework for the funding of pensions costs including, importantly, the principle of pass-through. We believe that the RPS will help to mitigate their perception of this risk, which could otherwise increase due to the factors listed above, leading to a more cautious approach to pension deficit recovery and the scheme's investment strategy. This, in turn, would lead to higher costs in RP3 and beyond. On this basis, we believe that an RPS will be a positive support to the Trustee's assessment of NERL's financial strength when undertaking the formal triennial valuation at 31 December 2020 (and at future valuations) and considerations of the recovery plan required to deal with a funding deficit.

45 We are disappointed that the CAA was not able to finalise its consultation on the RPS in December 2020, as had been its stated intention[6], and with the importance of a swift publication recognised by CMA in its final decision. Nevertheless, we will strongly encourage the Trustee to rely on the draft RPS provided in CAP 1994 when undertaking its formal valuation and assessing the strength of NERL's covenant, in anticipation of the final RPS being in similar form. Inevitably, the valuation and resulting deficit repair plan will not be agreed until after the CAA publishes a final RPS and, as cash contributions are an important input to NERL's revised RP3 business plan, this will delay engagement with CAA and its advisors on projected pension costs for the new price control period.

46 The CAA requested that NERL and its pension Trustee should consider how they can demonstrate the benefits to consumers that will flow from an RPS on NERL's pension costs. As we explained in our October 2018 business plan, we believe that an RPS would enable the Trustee to adopt a long-term funding and investment target that strikes the right balance between the interests of our

[6] CAA 2019, *UK RP3 CAA Decision Document: CAP 1830*, paragraph 5.78, and CMA 2020, *NATS (En Route) Plc /CAA Regulatory Appeal final decision*, paragraph 11.11

customers and the long-term strategy of the scheme. All other things being equal, if the Trustee can place greater reliance on the employer's covenant over the long term, then higher investment returns (and associated risk) can be targeted in the long term investment strategy which could lower the expected long-term pension contributions and hence prices. For our October 2018 RP3 business plan, our advisors estimated that the approximate impact on the assets required to meet the long-term funding measure would be around £400m for every 0.25% change in assumed long term discount rates. This was intended to illustrate the potential difference that an RPS could make on the assets required to meet the Trustee's long-term funding target, through regulatory support that would, in the first instance, mitigate any Trustee intent to decrease the long-term discount rate further and potentially enable an increase in discount rate. The gap to any long-term funding target would be met by a combination of contributions and investment returns over time. A change in the long-term funding target (through an increase to the long term discount rate) could therefore be expected to benefit customers by way of either reduced costs (from lower contributions) and/or reduced risk and volatility of cost (due to less investment risk required) to close any gap.

47 The updated figure, derived consistently and based on information provided by the Trustee, is estimated as £427m as at 24 November 2020, so still the same order of magnitude as previously indicated. This is the impact on the Scheme as a whole. However, if one attributes the impact solely in relation to NERL liabilities (c.75% of total Scheme liabilities, with NSL making up the balance), then this equates to c.£320m.

48 It is not possible to derive from this total a simple estimate of annual cost avoided, and hence impact on user charges per year in the current or next price control period, given the range of assumptions about investment returns and the timing of contributions on which the total is based. Nevertheless, by way of context, £400m represents some 8% of the total pension liability of the scheme of around £5bn, illustrating that the proposed RPS, once confirmed, would have a material impact on moderating the overall cost of meeting the pension scheme obligations. If the Trustee were to agree that having the RPS in place enables them to focus solely on the agreed Long Term Funding Target and remove the ability to continue towards their Even Longer Term Funding Target from their existing funding basis, then there should be an immediate benefit on the deficit at 2020 and an immediate impact on the recovery plan contributions required.

49 Our primary concern with the text of the draft RPS relates to the affordability principle, on grounds of feasibility and unintended consequences:

> *Principle 1, paragraph 4: "We expect NERL and the Trustee to provide evidence to demonstrate that … they have taken steps to ensure that the level of NERL's pension costs remain affordable."*

50 We believe that affordability can only be assessed in the context of NERL's overall business plan and its deliverables. As a policy principle for pension costs in isolation, we believe it is misplaced and risks undermining the value of the RPS generally. "Affordability" is subjective and, unlike many other companies in the UK with defined benefit pension schemes, there are very limited legal options available to NERL and the Trustee in terms of amending the benefits for future accrual with the future service cost primarily driven by financial market conditions, which are outside of the control of NERL and the Trustee. Where the Trustee and NERL each have flexibility in their respective domains to influence overall future service cost is through the amount of risk and return they are willing to take in the investment strategy. In order to reduce costs, and make them more "affordable", more investment risk would need to be taken. This creates issues for reasons set out below. Instead, we strongly recommend that "affordable" should be replaced by "efficient". This would be consistent with a view that customers should only pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, for NERL staff, with an

assessment of this package as a whole in line with comparative benchmarks. Given that we have previously set out in our RP3 Business Plan the steps NERL has taken (with the Trustee where appropriate) to mitigate the overall cost of the scheme, and the limited options remaining for further mitigation due to legal constraints, we believe the CAA should assess efficiency of pension costs by reference to factors such as the assumptions underlying the scheme valuation, the stewardship of the scheme and the investment strategy (taking account of the CMA's recent review of these costs as part of its August 2020 final determination).

51 In terms of unintended consequences, a key cost determinant in funding the pension scheme is the investment strategy and the level of risk within that investment strategy. Investment strategy is a trade-off between return (assets which are expected to generate higher returns are preferred to assets with lower expected returns) and risk (minimising the risk that sufficient assets are not available to meet scheme obligations as they fall due). Other things being equal, one would expect an investment strategy with lower return-seeking assets to result in lower investment returns and therefore higher employer contributions but with less risk, less volatile funding and potentially less volatile employer contribution rates. The converse would also be true. For these reasons, we believe that affordability is not an appropriate principle for the RPS as it implies a short-term regulatory judgement on investment risk from a customer-only perspective without regard to the long-term obligations of the pension Trustee or a balance between the present and future customer base. As such we do not believe that it would be appropriate for the CAA to be taking a view on and directing the balance of risk and return for the Trustee against their primary obligations, which are well established in law outside of NERL's regulatory framework.

1.2. Responding to issues for the new price controls from 2022

1.2.1. Uncertainty about traffic volumes

52 We recognise the concern described by the CAA about the impact of traffic uncertainty on resetting prices in the near term, as described above. While this uncertainty is likely to remain with us for some time, our view is that it would benefit airspace users if prices were reset from 2023 onwards based on latest traffic outlooks. While there could still be uncertainty about traffic levels as we approach 2023, it is likely to be significantly less than that for 2022. If, on the other hand, they were reset from 2022, then prices in 2022 would be higher than otherwise, as a result of the dominating influence of lower traffic levels.

53 The delay to the start of 2023 would defer any increase in UK regulated ANS charges arising from the pandemic to 2023, 12 months later than envisaged for the rest of Europe, giving UK customers a clear affordability benefit as they build back their flying programmes.

1.2.2. Identifying efficient costs

54 We agree that the extreme uncertainty created by the impact of the pandemic creates further challenges in establishing efficient levels for operating and capital costs. In seeking to identify such efficient levels, both for the purposes of 2020 and 2021 cost reconciliation and the following five-year price control period, we would encourage the CAA to take account of the following factors:

- Cost reduction versus cost efficiency: the need to distinguish between actions taken to reduce costs and cash outflow in 2020 and 2021, in direct response to the need to conserve liquidity as the pandemic impact grew, and other actions over a longer timeframe that might improve cost efficiency. Some of these shorter-term actions will not be sustainable even in the recovery period – for example, the reduction in staff costs from the Government's furlough scheme;

- The difference in the speed and cost of change in operational and non-operational spending, both reductions in response to the pandemic and subsequent increases in response to forecast recovery of demand;
- The need to maintain a safe, high quality and resilient service during the recovery phase, when the pattern of demand and the level of growth over time and regionally is likely to be considerably more volatile in future than in the recent past, combined with the extra challenge of providing operational staffing resilience to CV19 outbreaks; and
- The requirement on NERL, reinforced by the CAA's draft findings in the Palamon investigation, to bring forward plans for a more efficient and resilient service, which would manage short and longer term resource issues to match the service to demand as it emerges across different sectors within the network. Allied to this requirement there needs to be greater clarity from the CAA for NERL and its users on the service standards against which NERL should build its business plan, and against which its service performance would subsequently be judged.

55 We agree with the CAA that the incentive framework set by regulation should encourage NERL to take a holistic approach to securing benefits from its capital investment, including benefits measured in terms of safety, service quality, capacity, resilience, customer operating costs and NERL operating costs. In that context, we note that following the end of the transition period for the UK's exit from the European Union, there may now be scope for NERL to work with the CAA and DfT to ensure that the ATM functionalities envisaged by the Pilot Common Programme (and hitherto delivered under the auspices of an EU programme) are now more closely tailored to the specific needs of UK airspace users.

56 The nature of NERL's regulated business is such that costs are relatively inelastic to reductions in demand. Our previous analysis (based on normal economic cycles and the expectation that changes in traffic levels from forecast were likely to endure) suggested that some 85% of costs were fixed in the medium term[7]). The extreme nature of the pandemic shock has meant that some actions have been possible this year to reduce cash outflow which were not previously contemplated (such as temporarily closing the college), and there has been extraordinary support from Government via the furlough scheme. The prospect of recovery starting in 2021 means that we have also had to plan for the potential of a rapid bounce-back in demand. There is a significant lag between spending on training and the provision of capacity. This means that some operating costs, having been sharply reduced in the immediate response to the pandemic, may need to grow again in advance of projected recovery in traffic. These two effects would together tend to moderate the level of operating cost reductions which might be achievable in the recovery period. We will be seeking to maintain as much as practicable of the current cost savings through the longer term to the benefit of our customers, especially arising from the recent voluntary redundancy programme. However, there will be constraints because of the need to recruit contractors for the investment programme and re-open the college to assure ATCO supply, amongst other factors, as demand rises.

1.2.3. Setting effective incentives

57 The CAA sets out several challenges in setting efficiency incentives in the next price control:

[7] NERL 2018, *Regulatory Business Plan, Appendices*, page 84

- Calibrating cost incentives effectively, in light of the much greater uncertainty around future demand, including the sharing of efficiency gains between NERL and its users;
- Avoiding unintended consequences;
- Ensuring that capital expenditure incentives and governance arrangements allow NERL to take due account of the impact of its investments not only on service quality and efficient capital expenditure, but also in relation to delivering more efficiency in terms of operating costs; and
- Calibrating sufficiently challenging delay and flight efficiency targets and determining the appropriate strength of incentives.

58 We agree that these are important regulatory challenges for the next price control review. We urge caution, though, in seeking to fine tune the regulatory framework to deliver several desired outcomes, against a background of high levels of uncertainty. In this context, regulatory changes may fail to deliver their desired incentives into the business and could easily distract from more well established mechanisms which are well understood throughout NERL and by its users, and have recently been validated through the CMA review.

59 In addition, especially when some of the outcomes are potentially in conflict with one another, such changes could have unintended consequences. It is unclear that attempting to sharpen the incentives for efficiency at this time would achieve the desired outcome of furthering users' interests. This approach appears to assume that there is an as yet untapped source of efficiency savings within NERL's cost base which just needs to be incentivised to be revealed. There is no evidence for that. NERL therefore considers this to be a false premise on which to base a fundamental review of regulatory incentives. In particular, such efficiency savings were not identified by the CMA in its recent review. In addition, moving in this direction would, as the CAA acknowledges, likely place further risk on NERL, with adverse consequences for the cost of capital. Misplaced efficiency incentives could also have adverse impacts on service. Overall, this approach may yield no further cost efficiencies than a well-calibrated update of the current framework, but instead lead to a higher cost of capital, and possible impacts on service, leading to an overall negative outcome for users.

60 The only data that are available to compare NERL's performance to its European peers are the ATM Cost Effectiveness (ACE) Benchmarking reports. For one of the main ACE indicators – overall financial cost effectiveness for Gate to Gate (i.e. including En route and Terminal charges and costs of delay), NATS is second best in class of the 5 ANSPs in its comparator group. NATS also scores very well for other key efficiency metrics in its comparator group. NATS is second best in class on economic cost effectiveness, second best on ATCO-hour productivity, and second best on support cost per composite flight hour.

61 Our analysis of publicly available information indicates that NERL has also responded more quickly and significantly to reduce its costs in 2020 in response to the pandemic compared to other European ANSPs[8]. As discussed at paragraph 22 above, though, not all these savings are likely to be sustainable in the context of a return to more normal levels of operation.

[8] Barclays Equity Research 2020, *ENAV*, 13 November

1.2.4. Maintaining an efficient cost of capital

62 We agree that the economic impact of the pandemic is likely to have shifted the perceived and actual risks in the sector, and that the CAA will need to take account of this in setting the cost of capital for the next price control period to ensure NERL does not find it unduly difficult to finance its licensed activities. We would encourage the CAA to continue to take a holistic approach to setting the allowed cost of capital in the context of the whole price control settlement, including the financial parameters, incentive mechanisms and accompanying regulatory policy statements.

63 The stability and clarity of the regulatory framework is very important to the continuing ability of NERL to finance itself without undue difficulty. The market perception of NERL's risk is influenced to a very large degree by the design and implementation of the overall regulatory framework. By maintaining as far as practicable the current revenue and cost risk sharing mechanisms, the CAA would enable NERL to continue to raise private sector capital at efficiently low long-term rates, to the benefit of users.

2. Policy options

64 This section responds to the issues raised in Chapter 2 of the CAA's consultation paper.

2.1. Rolling forward the current regulatory framework

65 The CAA highlights that maintaining an approach based around the existing regulatory framework has the advantage of regulatory consistency and stability. We agree with this approach, which we consider would be in users' interests by enabling us to raise capital efficiently and to invest effectively to deliver long-term benefits for users in terms of safety, service, capacity and resilience

66 We also agree that it may be necessary to consider changes to this framework to a limited degree in order to take account of users' interests as well as NERL cost efficiency and financeability, given the impacts of the pandemic economic shock. In our view, users' interests are likely to be best delivered on a sustainable basis from a regulatory settlement which is firmly based on clear long term incentives on NERL to deliver safe, cost efficient and resilient services, and which enables NERL to attract capital to finance its investment programme. To that end, simple changes to established parts of the regulatory framework (such as the proposed modification of the TRS mechanism) are likely to be more effective than entirely new incentive structures.

67 The CAA notes that changes to the regulatory framework may be necessary to protect the affordability of charges during the period of recovery from the pandemic shock. We encourage the CAA to take a holistic view of users' interests as well as the range of options available to it. As noted above, users' interests extend beyond simply the "affordability" of charges in the near term, taking account of shorter term and longer term as well. Users' interests include the benefits of a resilient, high quality service, responsive to changing levels and patterns of demand as traffic fully recovers. NERL's economic regulatory framework defines its ability and incentives to invest to improve capacity, service and to deliver airspace modernisation over the coming decade. The CAA can also improve the affordability of charges to users during the sector's most critical recovery period by delaying the start of the recovery of revenue until 2023 and also extending the recovery period.

2.2. Improving incentives for efficiency

68 We consider that the current regulatory framework, recently endorsed by the CMA in its own review, provides effective enduring incentives for NERL to secure cost efficient and economic outcomes, in the interests of users, and subject to its overarching safety objective.

69 This is borne out in recent years by NERL's competitive charges compared to those of its European comparator ANSPs and its even stronger performance on cost effectiveness for airlines (taking account of delay costs as well as charges, as highlighted at paragraph 60 above). It also shows up in 2020 in the near-term responses of European ANSPs to the pandemic shock, where NERL has taken strong and early steps to reduce costs.

70 As noted above, given the heightened uncertainty about demand in the recovery period, even from 2023 onwards, there may be a case for reassessing how best to calibrate the existing suite of efficiency incentives. It is not clear to us, though, that attempting to sharpen the incentives for

efficiency at this time would be likely to achieve the desired outcome of furthering users' interests. This approach may yield no further cost efficiencies than a well-calibrated update of the current framework, but with a higher cost of capital, leading to an overall negative outcome for users.

2.3. Other measures to support affordability

71 We agree that the best options for dealing with affordability include extending the period over which NERL recovers the reconciliation of Traffic Risk Sharing revenue from 2020 and 2021. We consider that deferring the period of recovery to start in 2023, and extending it to 5 years from the current single year, would be a good starting point for taking into account user affordability as one aspect of the balanced settlement alongside the CAA's other duties. This measure could be combined with deferring the price control reset to 2023, thus postponing by 12 months the point from which charges would rise above the levels determined by the CMA's decision in August 2020. Based on initial modelling against a range of scenarios, we consider that these two measures together would enable the CAA to strike a balanced, affordable settlement within the existing regulatory framework, in which costs continue to be recovered in full via charges and shareholders could expect to earn a return on capital reflective of the risks they are bearing.

72 We therefore strongly disagree with the approach outlined by the CAA in which "if it were essential to support affordable charges, we would consider additional measures in the exceptional circumstances of Covid-19". The CAA defines these additional measures as shareholders bearing a proportion of the shortfall in the recovery of TRS revenue, and/or a proportion of any significant increases in NERL's defined benefit pension scheme costs. These would represent significant, disproportionate and, in large part, retrospective changes to the regulatory framework that would fundamentally alter NERL's risk profile to the detriment of financeability, the long-term cost of capital and ultimately users' interests. In our view, affordability for users during the recovery period following the pandemic shock can be delivered by deferring and moderating the projected increase in charges from 2023. This can be achieved by means of changes to the TRS recovery schedule and a price control reset from 2023. Based on modelling of a range of traffic scenarios and TRS recovery schedules, we believe that NERL's balance sheet is sufficiently strong to enable us to protect affordability of user charges over the whole period, from 2020 to 2023 and the subsequent 5 year price control. This belief is based on the expectation of support from the CAA for any necessary temporary increases in NERL's gearing above the current cap of 65%, and takes account of shareholder support through dividend restraint already committed, to maintain liquidity and so moderate charge increases.

73 The additional measures suggested by the CAA would not therefore likely be necessary. If they were implemented, there is a risk that they could be self-defeating. It is inevitable that they would increase the cost of capital and the cost of servicing the defined benefit pension scheme, to the detriment of user affordability for an extended period.

2.4. Additional equity support

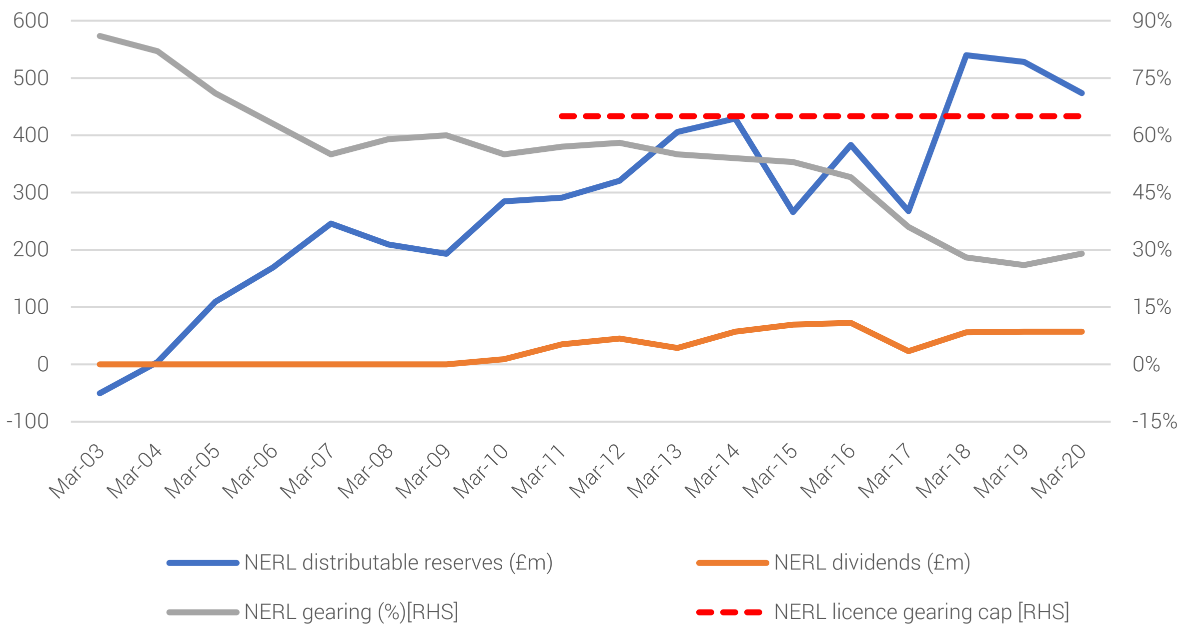
74 NERL and its Board recognise that shareholders have a part to play in enabling the CAA to meet its statutory duties towards users' interests and NERL financeability. In assessing what future regulatory changes may be necessary and the role of any shareholder contribution, the CAA should consider the track record of NERL shareholders in recent years and going into the pandemic as well as what will be required coming out of it. The continued appetite of equity investors to maintain or increase their holdings in the company will depend critically on the risk-reward terms which shareholders perceive from the regulatory parameters and associated statements set by the CAA. If these terms are assessed to have moved negatively, it should not be assumed that equity

finance, being an essential component of overall financing, would continue to be available on an equivalent or even comparable basis versus today.

75 NERL has adopted a prudent long-term approach to financing: this has been an essential platform for its current response, notably securing short-term commercial bank refinancing in August 2020 and its planned further refinancing during 2021. Over the past decades, NERL has built up reserves and shown historic restraint in declaration of special dividends and in dividend distribution generally (see Figure 1 below - 2015 and 2017 reserve levels were affected by pension scheme accounting valuations). This has meant that we are able to support customers through utilisation of reserves that have been built up over time in order to absorb the initial economic impact and support funding.

76 This prudent and considered approach by the company and its shareholders facilitated both shorter term liquidity in the form of existing but undrawn bank facilities, which were available for the immediate impact of the pandemic stress, and the foundation of low gearing and a solid investment grade credit rating for securing the additional bank facilities. This long term strategy has resulted in a declining trend in gearing over an extended period since 2003, a long way below the 65% gearing cap, allowing a significant portion of equity returns to be retained and re-invested in the business as capital contribution to the medium term resilience of the business.

Figure 1 NERL distributable reserves and dividends compared to gearing and potential dividends



77 The retained dividend capacity represented by the gap between actual gearing and the gearing cap has enabled NERL to increase borrowings to weather the cash flow impacts of the pandemic without breaching its regulatory commitments. It also represents the premise on which any rephasing of revenue recovery under the TRS will be financed, which in itself will effectively constrain the company's ability to pay future dividends. This represents a significant contribution by shareholders to the affordability of NERL charges for users.

78 The company was quick to recognise the financial threat of the pandemic. No dividends were paid in the 2020 calendar year. With regard to future dividends, the terms of the current bank facilities due for refinancing during 2021 are such that NERL will remain unable to pay dividends whilst these are in place. Beyond that the company will be constrained by its heightened gearing position.

Therefore, we do not accept that additional measures above and beyond those described here, including shareholders bearing extra costs, are either necessary or even effective to support "affordability". This approach would fail to recognise the significant contributions already made by shareholders through forgone dividends. It would also materially increase the risk for shareholders, subsequently raising the cost of capital, and therefore reducing affordability to users over time.

2.5. Dealing with future uncertainty

79 As set out above, in our view, there would be advantages from maintaining as far as possible the regulatory framework and the risk-sharing and incentive mechanisms therein, and then adjusting the quantitative parameters within this to set an appropriate balanced settlement. Introducing policy innovation at this stage risks introducing complexity and additional instability into the regulatory review, which will already be challenging for all parties given the degree of change in the underlying demand and cost factors and the need to complete the review to a tighter timetable than normal. In this context, we do not agree that reassessing the detailed design of the TRS for the next price control period would be either necessary or desirable.

80 Similar arguments would caution against modifying the design of the price control to allow higher levels of expenditure where traffic recovers more quickly than forecast. There is an inevitable lag between an upturn in forecast traffic demand, spending on additional capacity to meet such demand, notably ATCO training, and the delivery of additional capacity to the operational front line. So setting a tight price control with the scope for costs to rise rapidly in response to emergent demand could well result in a service which is less resilient than customers desire (albeit with lower charges in the short term) and does not effectively support the recovery of the aviation sector. At a time of forecast uncertainty, we will need to plan for a resilient service, which can cope with some greater variance in outturn traffic around the forecast level than we have hitherto factored in. We will also need to engage closely with our customers to ensure that we understand how traffic is recovering in the short-term, and where we might need to make tactical changes to our resourcing plans. Both actions are emphasised in the recommendations of the CAA's draft Palamon investigation.

2.6. Providing sufficient funding to support airspace modernisation

81 We agree with the emphasis placed by the CAA on providing sufficient funding to support airspace modernisation. NERL has a key role to play, where investment by NERL is complementary and enables investment by others to optimise benefits. It is in users' longer-term interests that NERL invests in a timely manner to deliver the strategic vision of a more efficient, higher capacity and lower environmental impact airspace plan for the UK.

3. Process issues

82 This section responds to the issues raised in Chapter 3 of the CAA's consultation paper.

3.1. Confirmation of our approach to TRS

83 Our views on TRS are set out in section 1 above of this response.

3.2. Timing and duration of the next price controls

84 We consider that setting a new price control at the start of 2022 is neither practical nor feasible, because we estimate that the review and assurance that is required in the resetting process will take more than a year and probably closer to 18 months (see Figure 2 in Appendix A).

85 Even if the review were very focused and all parties were willing to compromise significantly on review timescales compared to a normal price control, there would still be the risk of missing out on important evidence about traffic and its consequences for our future operations and investment, to the detriment of NERL and our customers. Importantly, resetting the price control earlier than 2023 would face a significantly higher risk of actual traffic being 10% greater than planned, which has been a trigger under SES for considering another price control reopener. This could render the RP3i reset exercise becoming redundant – potentially almost immediately. As highlighted in Table 1 in the Appendix, it would be necessary to start a new price control process now to reset it in Q2 2022, and we do not have the information to do that robustly.

86 During RP2, the CAA launched its first investigation as to whether NERL had failed to meet the reasonable demand of its customers less than half-way through the price control period[9]. In NERL's view, one of the key causes of the delay experienced within particular areas of airspace was the unforeseen increases in traffic[10]. This traffic growth was over 15% higher than expected at Luton airport and almost 10% at Stansted airport while it was only 4.1% higher than expected for UK flights overall. It is not difficult to imagine that current traffic scenarios will be more than 10% wrong, with the risks that creates for business planning for NERL and the additional costs for all stakeholders of beginning again the cycle of matching resources to traffic, desired capacity, resilience and service levels.

87 We strongly support the next price control lasting for 5 years, from 2023. This would provide a more stable background against which we would be able to plan and then deliver longer term capital investment more effectively than if we were subject to a series of shorter interim controls. It would also provide a much stronger incentive framework for NERL to seek to discover and implement cost efficiencies, including "invest to save" measures that may only payback over several years. We would also welcome the opportunity for an April 2023 reset if possible, to align with our financial year reporting cycle: this would simplify reconciliation for all stakeholders of our

[9] CAA 2017, *Notice of investigation: CAP1527*, March 2017

[10] CAA 2017, *Investigation under section 34 of the Transport Act 2000: Project Oberon, Final Report: CAP1578*, page 31

public statutory accounts and the regulatory analysis which underpins our price control, simplify our accounting processes and ultimately reduce costs to customers. This would require a simple bridge from the CAA or either rolling the CMA Final Determination forward by three months or a new CAA decision for five years and three months.

3.3. Price control review process

88 We agree that there are benefits to NERL and users, consistent with CAA statutory duties, from the CAA setting out the principles that will underpin its approach to modifying the TRS early this year, to support NERL's refinancing of its bank facilities later in 2021.

89 We suggest that this policy issue is developed, consulted on and a Licence modification concluded by Q4 2021(at the latest), separate from a longer-term price control review for the period beyond the CMA control period (i.e. from January 2023). This reform, on its own, would mitigate the projected sharp increase in charges that would otherwise occur in 2022 if the current TRS mechanism operated as currently defined in the Licence.

3.4. NERL business plan development

90 We estimate that the minimum time NERL would need to develop a business plan is nine months (compared to fifteen months it has taken through a number of iterations in the past), based on assumptions, set out below, about the explicitly narrower scope of this review and our ability to conduct focused customer consultations, and the elapsed time for the various stages which are set out in Appendix A . Such a timetable involves:

- Agreeing a strategy with the NERL Executive team that then provides direction to the business – 1 month
- Pre-work by business planning team, including work on an internal traffic forecast – 2-3 months
- Business area cost projections and review – 2 months
- Pulling together data on overall plan and ensuring its consistency – 2 months.

91 However, this relies upon strong guidance about traffic, targets and other key assumptions to the business plan from the CAA. We do not believe that the CAA is able to provide this information early in 2021, as would be required for a new price control in 2022, given the ongoing uncertainty in the aviation sector. However, the European Commission's ambition is to set performance targets for European ANSPs by 1 May 2021, which would provide a point of reference to the UK.

92 We suggest that we use the limited time for consulting with customers and developing the business plan to focus on the most salient issues of traffic recovery and associated topics around capacity, resilience, service levels and the investment programme that would best support the recovery phase. For example, we do not consider that it will be necessary to revisit, beyond essential updating of figures, cost allocation, non-regulated income nor the capital governance regime. These topics have been recently evaluated as part of the RP3 price control, including consideration and determination by the CMA, and there have been no significant developments for our implementation of them. While the same principle holds true for the ADS-B technology for our Oceanic operation, we recognise that there is an outstanding remit from the CMA inquiry for an independent assessment of the costs and benefits of this service, and it will therefore need to be discussed again with our customers in this context.

3.5. Stakeholder roles and customer consultation

93 Given the work that has recently been done by the CAA as part of its RP3 review, and strengthened through the CMA reference, we believe it could be possible to conduct customer workshops in a six week period by focusing on:

- Traffic;
- Targets, including cost efficiency;
- Capital expenditure; and
- Oceanic.

We would intend to hold consultations only on these elements and would not be in a position to have published a comprehensive plan prior to the start of the consultation. We would endeavour to ensure that such streamlined arrangements were accessible to and encouraged participation by our customers. The success of this approach, as with any consultation, would though depend on customers engaging fully with the process, and that the right people in each customer organisation were empowered to take appropriate decisions as the review progressed. We believe our customers will have limited capacity to engage in these processes before summer 2021. This is due to key airline staff being placed on furlough again following the latest January 2021 lockdown, which could continue until Easter 2021.

3.6. Review of space-based ADS-B

94 We look forward to further engagement with the CAA on the specification of the proposed review of space-based ADS-B. We support the CAA's previous approach of taking a wider perspective by looking at broader benefits to society in assessing the ADS-B business case.

95 In the context of the RP3i review, we believe it is important that the CAA avoids retrospective reconciliation or assessment with the benefit of hindsight – when NERL made the investment, different levels of traffic were expected in the short-term (and will return in the medium-term). The costs and benefits of ADS-B should be considered over its lifetime.

Appendix A: process and start date implications

Figure 2: RP3i review – minimum timeframe based on milestones

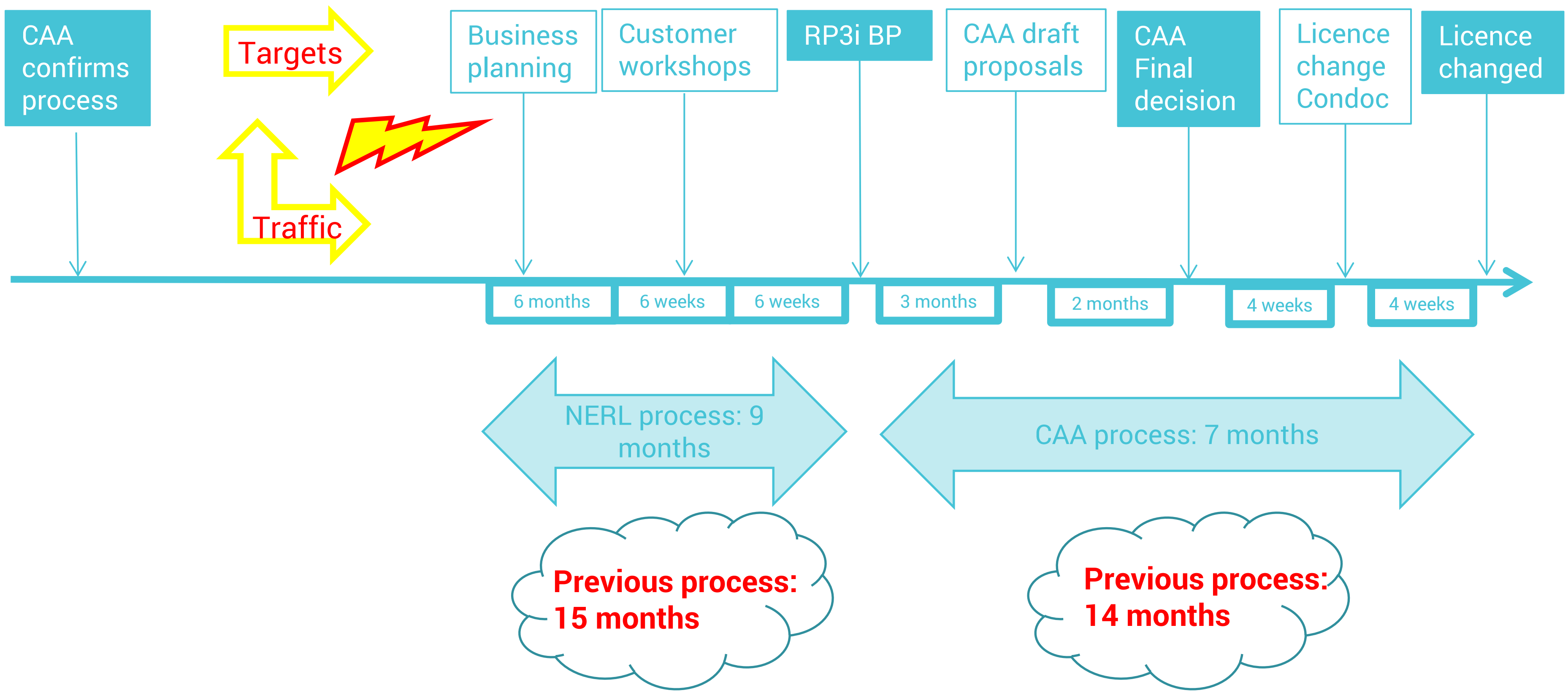


Table 1 Start date implications

Milestone	1 April 2022 deadline	1 January 2023 deadline
Licence changed	31 March 2022	31 December 2022
CAA Final Decision	17 February 2022	19 November 2022
CAA Draft proposal	17 December 2021	19 September 2022
NERL RP3i BP	17 September 2021	May 2022
Customer workshops	17 June-29 July 2021	Jan-March 2022
CAA provides guidance to NERL on targets (EU-wide performance targets by 1 May 2021)	17 March 2021	September 2021
NERL Business Planning	January-17 June 2021	July-December 2021
CAA confirms process	February 2021	February 2021