Regulatory Policy Group
Economic Regulation

Mr Nigel Fotherby
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Dear Nigel

We agreed that CAA would write to you setting out our requirements for your Revised Business Plan (RBP). To a large extent this updates my letter of 14 March for the Initial Business Plan taking account of the Performance Review Body consultation document dated 17 May. I have, however, repeated the content that has remained the same so that this letter can serve as a standalone reference.

Our views are based on our current understanding of information available to us and our interpretation of SES requirements, and may change in due course. Furthermore, the views expressed to assist you in the preparation of your RBP and should not be interpreted as CAA policy. We reserve the right to change this guidance as we develop our understanding for RP2 and engage further with stakeholders or on the basis of guidance from the PRB.

Where the term 'the charging regulation' and "the performance regulation" are used in this letter, we mean COMMISSION IMPLEMENTING REGULATION (EU) No 391/2013 of 3 May 2013 laying down a common charging scheme for air navigation services and COMMISSION IMPLEMENTING REGULATION (EU) No 390/2013 of 3 May 2013 laying down a performance scheme for air navigation services and network functions.

General

We confirm:

- Financial and volume information should be presented on a calendar year basis.
- The Determined Unit Cost (DUC) target for the RBP refers only to the NERL component of the UK national target.

Start Point

The value of the 2014 start point for the DUC should be consistent with the PRB proposal. We currently understand this to be:

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- The NERL target that would have applied in 2014 if the EU wide target of an annual reduction 3.5% in the DUC had applied to the period 2011-2014 (we calculate this to be £48.87 in 2009 prices); **divided by**
- the ratio of (currently expected traffic in Total Service Units: to the Total Service Units assumed in the NPP) for 2014. (We calculate this to be [9,654k:11,035k] based on the STATFOR forecasts in the EUROCONTROL Intermediate Forecasts May 2013).

On the basis of the data currently available, this implies a starting base for the DUC in 2014 of £55.86. We note this start point will need to be reviewed in light of revised traffic forecasts and any updates to methodology (e.g. reflecting SU/TSU changes and/or PRB advice).

Recognising that there may be continuing consideration of this point we expect you to present again sensitivities based on: (a) no correction in 2014 for traffic variance in RP1; and (b) correction to the extent that the charging regulation would imply such risk sharing based on the expected traffic in 2014.

For the avoidance of doubt we do not consider that this approach represents a claw-back of value from RP1 but readjusts the evolution of unit costs to a long term trend.

DUC

While the key indicator is the DUC per Total Service Unit, the CAA recognises that this may not be the most effective format for preparing and presenting the NERL RBP based on existing systems which have been designed around allocating costs to Service Units. We therefore agree to NERL constructing the costs per Total Service Unit for the purpose of its RBP using the steps adopted for RP1 as follows:

A. As a first step deriving gross UKATS costs broken down into cost categories. (These categories should allow a mapping to the cost categories in annex II of the charging regulation but with "Defined Benefit" and "Defined Cost" pensions separately identified.)

B. Showing UKATS revenues from other sources including revenues from MoD.

C. Deriving net costs of chargeable traffic (A-C).

D. Showing "Service Units", which are defined as chargeable service units plus service units on civil exempt flights.

E. Deriving net costs of chargeable traffic per Service Unit.

F. Grossing up determined costs by (the Total Service Units/ Service Units), where Total Services Units are defined as Service Units plus service units on military exempt flights.

This approach is for the RBP and is without prejudice to amendment later in the RP2 process.

Efficiency

We are expecting one single base case in the RBP which:

- gives full regard to users' preferences on the trade-off between charges, flight efficiency and delay as identified in your Customer Consultation process. The RBP should set out how NERL has responded to feed-back from users during the Customer Consultation process.

- takes account of the expected level of targets at an EU wide level as set out in the PRB consultation document of 17 May, or any subsequent update from the Commission or PRB, as confirmed by the CAA.

Subject to customer preferences and evolving traffic forecasts we expect you to plan to meet <u>or surpass</u> the rate of reduction likely to be adopted by the EU. To that end we consider you should have regard to the targets at the upper end of the range (i.e. -3.0%p.a. for DC and -5.8% p.a. for DUC).

We expect NERL to exhaust all possible operational and financial efficiencies before seeking to reduce service quality in order to meet the efficiency targets at the top end of the range. Should NERL propose to degrade service quality in order to meet efficiency targets, it should clearly explain the rationale and quantification of the trade-off and the airline user support for this.

We expect NERL to identify clearly cost efficiency benefits to NERL arising from the UK-Ireland FAB during RP2.

Traffic Forecasts

For the purposes of the RBP, the CAA expects NERL to use the most recent STATFOR forecasts of Total Service Units. (The CAA has no objection to NERL considering the sensitivity of using its own forecasts).

Composition of the RP2 DUC – treatment of true-ups

For the purpose of the RBP, the composition of the DUC should exclude the true-ups which are permissible in the charging regulation and for which there is a component in the calculation of the unit rate in annex IV of the charging regulation. These exclusions include:

- the carry-overs resulting from the implementation of the traffic risk-sharing referred to in Article13 (3) to (5);
- the carry-overs from the previous reference period resulting from the implementation of the cost risk-sharing referred to in Article 14);
- bonuses and penalties resulting from the financial incentives referred to in Article 15; and
- for the first two reference periods, the over- or under- recoveries incurred by Member States up to the year 2011.

Our current interpretation of this is that it allows not only the truing up of the over- or under-recovery from traffic variances, inflation and the incentive elements but also the truing up of the variance in the relevant pension costs in RP1, to the extent that these qualify under Article 14. The wording of article 14.2(e) appears to allow the carry forward of such costs into the following period(s). For the purposes of the RBP we expect NERL to continue to recover these sums over 15 years through the RAB. NERL should, however, be mindful that these sums will need to be separately identified for the purpose of European reporting.

Composition of the RP2 DUC – allowance for cost of change

We expect the RBP to separately identify:

- restructuring costs with accompanying well articulated business case(s) that clearly demonstrate a net benefit to users over time.

- the non-capitalised cost of projects to achieve significant changes in procedures or processes (e.g. the change to transitional altitude, performance based navigation, LAMP, Northern Terminal Control Area) with accompanying business case(s). (We also expect you to identify the capital costs of each of these projects separately for information, but the normal process of depreciating capital assets will allow these costs to be recovered over the life of the assets created and the capital costs do not therefore require any special treatment to allow for change).

The charging regulation allows 'restructuring costs' to be removed from determined costs and separately identified where:

'restructuring costs' means significant one-time costs incurred by air navigation service providers in the process of restructuring by way of introducing new technologies and procedures and associate business models to stimulate integrated service provision where the Member State wishes to recover the costs in one or more reference periods. They may include costs incurred in compensating employees, closing air traffic control centres, shifting activities to new locations and, writing off assets and/or acquiring strategic participations in other air navigation service providers.

The performance regulation also recognises this definition of restructuring costs. ANNEX IV paragraph 5 makes provision for the assessment of whether cost- efficiency targets contribute in an adequate manner to the EU wide target to take into account restructuring costs as appropriate.

We note that NERL's March 2013 Business Plan included a voluntary redundancy plan that started in advance of RP2. Article 7.4, of the revised Charging Regulation, published in May 2013, makes provision for the recovery of restructuring costs of air navigation service providers incurred in reference periods precedent to the reference period(s) of recovery subject to a business case demonstrating a net benefit to users over time and a process of consultation with users and approval by the Commission. The CAA interprets this Article to apply ex-ante, so the CAA expects NERL to assume that there would be no recovery in RP2 of those restructuring costs incurred in RP1.

We believe that this should not apply to restructuring costs which reflect the normal run of business over a five year period as evidenced by historic experience. As a working assumption for the IBP we anticipate that NERL will separately identify restructuring costs and separate and exclude them from on-going costs. The CAA expects to assess what level of restructuring costs should be excluded from the DUC on the basis of the evidence presented. As an interim step, the CAA requests NERL to include in its IBP sensitivities on the DUC if the first £25m or £50million of restructuring costs were considered part of the normal course of business for RP2 and not excluded from the DUC. This is without prejudice to any evidence of what such a threshold should be, to emerge at some later stage of the RP2 process.

Profile

We acknowledge that there may not be a smooth path in the DUC and charges over RP2. We expect the plan to set out the implied charges before any profiling.

As a minimum requirement, we would currently expect any profiling to represent NPV of charges over the five years of RP2 no greater than would be the case if the DUC were subject to a constant percentage change. We do, however, ask you to consider that this approach may not necessarily be adopted by the PRB and Commission when they assess performance plans.

Scope

For the purpose of the RBP, we expect you to make no changes in relation to the scope and/or cost reflectivity of the London Approach or North Sea Helicopter charges compared to what was assumed for 2014/15 in the CP3 price control decision. Each element should be clearly and separately identified. This is without prejudice to a further consideration of the treatment of London Approach under the charging regulation.

Inflation

We expect:

- CPI indexation, measured as average annual changes in CPI prices, to be used to express the real reduction in DUC that is projected by the NERL business plan. NERL will use IMF data throughout the price control for all CPI inflation projections where possible. We note that IMF forecasts are not likely to be available for the whole period of RP2 and that NERL will apply the Oxford Economics forecasts of CPI inflation to the final IMF forecast CPI inflation index for the remaining years of RP2.

We acknowledge that for the RBP:

- RPI inflation forecasts will continue to be required to inflate the RAB, and for the calculation of regulatory depreciation and return.
- That you intend to adopt the RPI assumption calculated by adding the value of the 'RPI wedge' (the difference between CPI and RPI, sourced from the Oxford Economics inflation forecast) to the IMF CPI forecast.

We reserve the position of considering the wedge between RPI and CPI over the course of the review.

Regulatory depreciation

We confirm that we expect you not to make any adjustment to the regulatory depreciation of the regulatory asset base in the RBP.

FMARS income

For the purpose of the RBP we expect that the treatment of FMARS income from the MoD within the single till will continue unchanged in RP2 (i.e. the unit rate is adjusted downwards through the single till mechanism to take this revenue stream into account).

Cost of capital

We note that for the purposes of the RBP, NERL will assume a pre-tax real cost of capital based on its own assessment of an appropriate rate for RP1.

The CAA has not yet reached a view on the appropriate cost of capital for RP2 and does not endorse any value at this stage in the process. The CAA expects to consider the advice of its own consultants and any emerging evidence from European Commission advisers before it drafts the UK element of the relevant performance plan.

Recovery of under or over recoveries from RP1

The CAA expects NERL to assume that under- or over- recoveries from 2013 and 2014 allowed under the charging regulation will be recovered in year N+2 (i.e, 2015 and 2016 respectively) consistent with the CAA's decision in CAP1058. The CAA acknowledges that this first round of recovery will still be subject to traffic forecasts for year N+2. As a working assumption for modelling purposes the CAA proposes a second round of truing up these recoveries in year N+4. This is without prejudice to any pan EU approach which may be determined in due course.

The Rolling Incentive Mechanism

The CAA expects the rolling incentive mechanism to be applied as set out in Appendix 4 of the CAA's 2010 Decision on the price control for CP3.

Presentation of customer prices

We agree that the RBP should provide information on the future evolution of charges based on the performance targets for the DUC as modified by the other factors set out in the charging regulation.

A.Determined Cost for target setting purposes	**+**
B. Pension pass through in relation to CP3/RP1	+ or -
C. Restructuring costs (subject to CAA advice above)	+ or -
D. Subtotal Costs	**A+B+C**
E. Service Quality Incentives (relating to CP3 on n+2 basis)	+ or -
F. Traffic volume risk sharing (relating to CP3 on n+2 basis)	*+ or -*
G. Inflation adjustments (relating to CP3 on n+2 basis)	+ or -
H. Price profiling adjustments (CP3 only at this stage)	+ or -
I. Pricing below the cap (CP3 only)	-
J. Unit rates for customers	**D+E+F+G+H+I**

Oceanic

The CAA expects the RBP to include the respective building blocks for Oceanic. These should give full regard to users' feedback from your Customer Consultation process and be consistent in the level of ambition with the plan for UKATS.

We expect the plan to set out the implied charges before any profiling. As a minimum requirement, we would currently expect any profiling to smooth charges during the course of the control period to be equivalent in NPV terms to charges before profiling.

Modifications between the publication of the RBP and publication of a draft FAB plan

While not a part of the CAA's requirements for the RBP, you have asked the CAA to indicate what changes we are likely to adopt to the RBP before drafting a FAB plan.

Without prejudice to adopting alternative assumptions generally, based on advice from our consultant studies, having regard to European guidelines or advice or otherwise based on its reasonable discretion as economic regulator the CAA would expect to modify the plan, for example:

- to reflect material changes in forecasts by STATFOR;
- to reflect actual capex in 2013/14;
- based on actual information on the phasing of redundancy;

- actual pension costs for 2013 as they relate to the recovery of uncontrollable costs in RP1.

The CAA will apply a higher hurdle to modifying the plan to reflect changed expectations from NERL as these will not have been subject to Customer Consultation. The CAA will however retain the discretion to do so given that there will be a formal round of consultaion on the draft FAB plan.

The CAA reserves the right to change its position on any of the above issues, especially following consultation.

I am copying this letter to the Co-Chairs of the Customer Consultation and the CAA will publish a copy on its website.

Yours sincerely,

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