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British Airways response to Civil Aviation Authority Consultation CAP2553 on the economic regulation of NATS (En Route) plc Provisional Decision for the NR23 price control

Thank you for the opportunity to respond to your consultation on the CAA's Provisional Decision for NATS (En Route) plc ("NERL"); we set out below our views on the proposals and implications for the wider policy environment.

We have endeavoured to deliver as complete a response as possible, given the shortened timelines, and remain available for further engagement, either bilaterally or through consultation whilst the CAA further develops and refines its proposals ahead of making it Final Decision.

Our response is structured to follow the sequence of topics established in CAP2553 and read as follows:

1. Executive summary
2. Context and approach
3. Traffic assumptions
4. Service quality
5. 2020-2022 reconciliation
6. NERL's costs; operating and capital expenditure
7. Financial framework, including WACC
8. Charges and financeability
9. Regulatory incentives and mechanisms
10. London Approach and Oceanic

1. Executive Summary

a) We understand that the CAA's Provisional Decision is based on the latest credible information available to the CAA at the time of publication. Since the CAA formed the Initial Proposals, the external environment has moved on and it is appropriate that this has been accounted for in the CAA developing its proposals. We urge the CAA to ensure it has taken the latest information available into consideration up to the point of publishing its Final Determination, including updates to traffic and inflation forecasts as well as macroeconomic developments and market conditions.

b) We welcome that the CAA outlines that it has done further analysis on service quality, thereby strengthening its evidence to support its proposition, however we have not seen this analysis directly. The acceptance by NERL of the CAA's targets for 2023 so readily raises the consideration that are the CAA's targets stretching enough.

c) The CAA has fallen short of proposing a reasonable efficient baseline for NERL's operational costs in the period 2020-2022 and requires further adjustment to reflect the full extent of efficient cost levels that could have been achieved. We support recoveries to be made over a ten-year period, evenly split between NR23 and NR28 and profiled to present a flat real term price path in NR23.

d) The CAA must only include allowances for efficient operating expenditure and ensure that NERL is appropriately incentivised to become more efficient over time, in order to promote consumer benefits and deliver productivity comparative to that expected in a competitive market environment, fulfilling the CAA's duties as set out in TA00.

e) The judgement exercised by the CAA towards Graduate headcount appears inappropriate and against the findings of its own advisors despite lacking compelling evidence from NERL, as recognised by the CAA itself. We call on the CAA to reconsider its position and base its decision on the best available evidence.

f) We welcome the CAA's continued proposal for the introduction of a new DC scheme for new starters from 2024. British Airways urges the CAA to establish this allowance at an efficient and representative level and adopt the findings of its advisor, Government Actuaries Department (GAD), in providing an employer contribution rate of 11% based on the comparator of FTSE100 companies.

g) We support the adoption of GAD's findings in regard to NERL's DB scheme and for the CAA to only allow an efficient level of costs to be included in NERL's allowance.

h) With regard to the WACC, we re-iterate our concerns from the Initial Proposals and express fresh concerns over the CAA's and Flint's approach estimation of the asset beta. These relate to the pandemic uplift, the risk of double counting, the uncertainties around the inclusion of ENAV in the peer group, and the differing risk profile faced by the comparator airport groups. We also set out some recent findings by the French transport regulator over the arbitrary character of assumptions around the duration and frequency of pandemics.

i) We support the appointment of Egis to conduct a review of NERL's NR23 capex plan to assess the robustness of NERL's approach in revising the programmes in 2022, extent of efficiency and deliverability of the plan and the extent to which it delivers benefits furthering the interest of customers and consumers.

j) We continue to advocate the introduction of CPI indexation of the RAB for NR23. With TRS cost recoveries from 2020-2022 to extend beyond 2030, representing the withdrawal of the RPI measure of inflation indexation, the tail end of these adjustments will be in error by being based upon inconsistent inflation indices.

2. Context and approach

2.1. NATS (En Route) plc, known as NERL, is the monopoly provider of en route and certain approach air traffic services (ATS) in the UK and is subject to economic regulation by the CAA under the Transport Act 2000 (TA00), which sets out that the CAA has several duties to perform, primarily to exercise its functions in a manner to maintain a high standard of safety in the provision of ATS alongside a series of further duties[1].

2.2. Under its duties the CAA must exercise its functions, amongst others, in a manner it thinks best calculated; to further the interests of operators in regard of the availability, cost and quality of ATS, to promote efficiency and economy on the part of licence holders, to take account of any international obligations of the United Kingdom and to secure that licence holders do not find it unduly difficult to finance activities authorised by their licences.

2.3. The TA00 sets out that the setting of price controls and service quality incentives for NERL is one of the CAA's core functions and under its international obligations the UK is party to the Eurocontrol Multilateral Agreement relating to Route Charges[2] and has adopted the Eurocontrol common policy in respect of charging for en route services, as set out in the Eurocontrol Principles for establishing the cost base for en route charges and calculation of the unit rates[3].

2.4. In establishing the NR23 price control, the CAA is setting the maximum prices that NERL can recover from its customers as per the terms dictated in its licence[4], and are formed from allowances for efficient costs and forecasts for traffic volumes.

[1] https://www.legislation.gov.uk/ukpga/2000/38/part/I/chapter/I
[2] https://www.eurocontrol.int/publication/multilateral-agreement-relating-route-charges
[3] Eurocontrol Principles for establishing the cost base for en route charges and the calculation of the unit rates
[4] https://www.caa.co.uk/media/azlfstks/air-traffic-services-licence-for-nats-en-route-plc-january-2022.pdf

2.5. We fully support that the CAA's overriding priority for NR23, in keeping with its primary duty under TA00, is to ensure that NERL is economically regulated in a manner that allows for the continued provision of a high standard of safety in ATS in UK airspace and that safety must always be protected, where necessary at the constraint of air traffic. We expect the CAA's developed proposals would enable NERL to at least maintains its current safety performance.

2.6. NERL holds a monopoly position due to an absence of competition in the provision of UK air traffic services and as a result the CAA, under its secondary duties in TA00, must seek to protect consumers from the power of the monopoly, drive efficient outcomes in a manner akin to the competitive forces experienced in the open markets and avoid tending toward positions held by the regulated company, neither as a result of information asymmetry, nor due excessive regulatory caution that is incomparable with dynamic and competitive markets.

2.7. We advocate for the CAA to consider all available relevant information, to pursue attaining a substantive and defining evidence base wherever it is currently lacking and to adopt such information in developing its Final Determination. This includes but is not limited to information on opex items, traffic and inflation forecasts as well as the latest macroeconomic developments and financial market conditions.

Airspace Modernisation

2.8. The links and obligations maintained in the CAA's Provisional Decision between the Airspace Modernisation Strategy (AMS) and NERL's role in its delivery, including facilitating the Airspace Change Organisation Group (ACOG) function, are a key component of the NR23 period and reflect the position that airspace modernisation holds as a national strategic objective for the UK in its vision to "deliver quicker, quieter and cleaner journeys and more capacity for the benefit of those who use and are affected by UK airspace"[5].

2.9. In keeping with this strategic priority, it is imperative that through these proposals NERL is able to deliver on its obligations including airspace and technology initiatives; NERL should not be a hinderance to airspace modernisation as it occurs.

3. Traffic assumptions

3.1. Traffic forecasts are vital to establishing the suitable allowances for operating and capital expenditure necessary for delivering appropriate service quality outcomes by NERL, as well as providing the divisor for the calculation of the unit rates.

3.2. We continue to support the use of STATFOR forecasts, it is appropriate to continue the methodology used at RP2 and RP3 providing regulatory consistency and

[5] CAA CAP2394 p36

continued alignment with Eurocontrol Principles, whilst also ensuring that forecasts remain independent of the regulated company wherever possible.

3.3. The use of STATFOR's March 2023 base case forecast is consistent with previous price controls and appears appropriate for NR23.

3.4. We advocate that the latest information available to the CAA is considered, including considering outturn traffic levels and any further STATFOR forecasts published ahead of Final Determinations.

3.5. It is essential that any adjustments to traffic forecasts are reflected in the calculation of the relevant building block allowances. Users must be able to interrogate the evidence and model underpinning those forecasts and have opportunity to provide feedback on any material changes to the plan before NR23 is finalised.

3.6. We make our comments relating to Oceanic forecasts as part of our comments on the Oceanic plan.

4. Service quality

4.1. Appropriate performance incentives are a fundamental element of the price control, ensuring that the regulated company is incentivised to deliver the appropriate service quality required by users.

4.2. Service levels should reflect the level of opex, capex and traffic forecasts, ensuring that expenditure allowances are calibrated to the required service outcomes and that the outputs from investments are appropriately recognised.

4.3. Safety remains our highest priority, which we are not willing to see compromised under any circumstances, and we agree with NERL that it should be at the heart of their business[6].

4.4. Whilst not explicitly covered in the CAA's proposals, we continue to support the continued measurement of safety against the current range of metrics and NERL's proposal to continue to follow the European Risk Assessment Tool ("RAT") scheme complemented by other measures during NR23.

<u>Treatment of RP3 incentives</u>

4.5. The suspension of financial incentives for 2021 seems reasonable given the extent of traffic depression throughout the year and the impact this had on service performance.

4.6. It is currently unclear if it is appropriate to suspend the incentives for 2022 in its entirety or if it would be more suitable for special measures to be adopted and

[6] NERL Business Plan p18

consider the performance only from Q2, when traffic levels significantly increased towards pre-pandemic levels and users were actively encouraging NERL to deliver service quality performance to its targets. If the measures are deemed to have been effective in incentivising NERL during this period, it could be appropriate for them to be applicable. It is unclear if the incentives would, in our opinion, unduly penalise NERL were they fully applicable across capacity incentives.

4.7. We note that 3Di incentives have been suspended for 2023 as the annual review had been failed in the previous two years.

Environmental targets and incentives

4.8. We recognise that the 3Di metric represents the best available option at this stage and is highly preferable to the European KEA metric; as such we support its continued use in NR23 subject to the continued tests for each of its four parameters on an annual basis, which appears to hold heightened relevance due to the failure of the tests in 2020 and 2021 and the instability in the model that this highlighted[7].

4.9. We have raised our considerations on the 3Di metric in our response to NERL's Business Plan[8], and welcome NERL's commitment to work with its stakeholders during NR23 to evolve the 3Di metric ahead of NR28[9] to ensure it is a more representative measure of optimal flight paths.

4.10. It is our consistent view that targets and performance incentives should be calibrated to ensure that they are both achievable and incentivise performance improvement over time, calibrated for current performance, reflect previous developments and investments as well as improvements derived from capital investments and should ultimately be linked to the operating expenditure required to deliver the service.

4.11. It would be inconsistent to adopt NERL's proposed 3Di targets from its response to the CAA's Initial Proposals as NERL's updated figures were based on a traffic forecast not adopted by the CAA across the construction of its Provisional Decision and we support the CAA's decision to dismiss NERL's proposed updated targets.

4.12. It appears the CAA should update the start point on the 3Di target to match its own updated calculation, setting the start point target at 27.5 based on the steps highlighted by the CAA[10], although it is unclear from the explanation provided if this addresses NERL's concern that the start point in the CAA's Initial Proposals was calculated from NERL's ready reckoner tool that excluded non-revenue flights and thus the target should be adjusted upwards to account for the non-revenue flight proxy amount of 0.6[11].

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7 CAA CAP2394 p52
8 https://www.caa.co.uk/media/euacxaxy/british-airways.pdf p27-29
9 https://i.nats.aero/pubdocs/doc/appendix-f-environment/ p5
10 CAA CAP2553 para 2.32
11 CAA CAP2553 para 2.22

4.13. The application of 3Di benefits derived from the capex programme, outlined by NERL to be in the range of 2-3.3 score points[12], is an appropriate step although it remains unclear as to the assessment conducted by the CAA in determining the level of proposed capex plan benefits to be limited to 2.3 points. The consideration of NERL's proposed capex benefit of 2.3 in response to the CAA's Initial Proposals[13] appears questionable as NERL's response was based upon the October 2022 STATFOR traffic forecast and a SIP that has now been revised in the latest iteration, iSIP23.

4.14. We continue to support the CAA's assessment and proposal for the treatment of traffic modulation of 3Di targets, based on the analysis undertaken by the CAA on pre-pandemic traffic, for such a scheme to be suitable it must be based on clear, robust evidence to avoid the risk of perverse outcomes from diluted incentives.

4.15. Based on pre-pandemic historic data, as part of its RP3 determination, the CAA allowed an adjustment to 3Di targets and actual scores to exclude a proxy 0.6 score points for training, positioning, surveillance, calibration flights and other non-revenue flights which NERL proposed total removal of in its NR23 business plan, excluding such flights from targets and actual 3Di scores.

4.16. The CAA raised the concern that this generates a risk of inconsistency whilst still using the original 3Di model coefficients that included such flights and reducing the reliability of the modelling results[14], which potentially reduces the validity of the 3Di metric further and seems to be a reasonable concern.

4.17. We advocate for a more systematic method for addressing these categories of flights impact on 3Di scores, it would be inconsistent to remove these flights from targets and actual scores without conducting such an adjustment to the base coefficients; rather than dismiss conducting such a review for the round of NR23 we further advocate that such an assessment is considered for incorporation into the CAA's Final Decision and if this is not feasible, we would support an expectation that this is completed as part of a wider review of 3Di for NR28.

4.18. The proposed maintenance of the structure of the financial incentive similar to RP3 provides regulatory consistency and crucially allows sufficient time for incentives to play out following the changes made for RP3.

4.19. We support the expectation to review the 3Di metric and incentive ahead of NR28 to consider how the incentive can be strengthened and better targeted to reflect the considerable importance environmental concerns have for our business and customers.

4.20. Whilst 3Di scores can be influenced by factors outside of NERL's control, we believe it is the intent of the periodic review to recalibrate incentives across the whole price

[12] NERL Business Plan Appendix H page 8
[13] CAA CAP2553 para 2.33
[14] CAA CAP2394 p53

control and that where reopeners are used on specific areas in isolation this could risk an imbalance in the price control as many of the areas noted by NERL as having a potential impact on environmental performance would most likely have an influence on operating expenditure as well.

4.21. We are not convinced that reopeners are required at this time based on the CAA's assessment. The CAA's proposal for NERL to highlight any such one-off events and their impact on the 3Di score as part of NERL's quarterly performance reporting seems suitable.

Capacity targets and incentives

4.22. We reiterate our position that it is critical for NERL to be in a position to meet capacity demands as the industry recovers, mirroring the priority consumers also place on punctuality.

4.23. Given the compressed timescales associated with this periodic review it does not seem unreasonable to maintain current capacity metrics, enabling the continued comparison of performance, through C1 and C2 metrics, to NERL's European counterparts.

4.24. We welcome that the CAA outlines that it has done further analysis on service quality, thereby strengthening its evidence to support its proposition, however we have not seen this analysis directly.

4.25. The acceptance by NERL of the CAA's targets for 2023 so readily raises the consideration that are the CAA's targets stretching enough.

4.26. Consistent with our view of NERL's updated 3Di proposed targets, that are based on the October 2022 STATFOR, we believe NERL's updated capacity target proposal is inconsistent with the overall approach to the NR23 Provisional Decision and support the dismissal of NERL's proposed targets.

4.27. We support the basis of maintaining the C2 to C3 ratio for the reasons identified in the CAA's Initial Proposals, namely that NERL's analysis included observations impacted by covid-19 and as such we view are unsuitable for consideration as traffic has significantly recovered from 2020-2021 levels and continues to grow.

4.28. We do not support the change in direction regarding the modulation of C2 targets for the reasons the CAA itself identified in its Initial Proposals, namely that NERL's analysis of a subsection of delay codes only considered 36% of delay in 2019 and when the CAA considered all types of delay there was not a clear trend[15].

[15] CAA CAP2394 para 2.93

4.29. The extent of the traffic forecast uncertainty highlighted by the CAA has not been evidenced or justified [16]. We are therefore unable to assess if the introduction of the C2 traffic modulation is appropriate.

4.30. Similar to our comments on the modulation of the 3Di targets, the introduction of target modulations must be based on clear and robust evidence to avoid the risk of perverse outcomes from diluted incentives. The CAA's proposed introduction of C2 modulation does not appear to fulfil these grounds. We advocate for the CAA to reconsider its proposal and base its decision on the evidential findings it outlined in its Initial Proposals.

4.31. The proposal for the inclusion of 100 exemption days continues to lack justification on the basis of evidence provided by NERL to date[17] and the CAA's findings in Initial Proposals that the NR23 capex plan is smaller than the original RP3 plan[18]. In fact, the exemption day allowance was increased from 75 days to 100 for RP3 based on the capex plan intended for RP3. Given the lack of compelling evidence to justify the level of exemption days required in NR23, it appears appropriate that the CAA revert to the RP2 allowance of 75 days, or fully justify an alternative allowance, to reflect the smaller capex plan with reduced number of transitions for NR23.

4.32. We reiterate our position that there should be a clear link between the number and extent of planned transitions within NERL's capex programme and the level of exemption day allowances. Without being appropriately calibrated the allowance risks undermining incentives.

4.33. The proposed maintenance of the structure of the financial incentives similar to RP3 provides regulatory consistency and crucially allows sufficient time for incentives to play out following the changes made for RP3.

5. Reconciliation review

5.1. An ex-ante traffic risk sharing (TRS) scheme was in place for NERL and other European ANSPs in RP3, following its precedent in RP2, under European charging rules and Eurocontrol Principles, which provided a consistent condition of protection to NERL for unexpected variations in traffic levels.

5.2. Following the onset of the covid-19 pandemic, the CAA committed to conducting a TRS reconciliation through the review of actual traffic levels and efficient actual costs for 2020 to 2022, which we support in that it should be assessed against information that NERL had available to it at the time of making its decisions and not be judged with the benefit of hindsight.

[16] CAA CAP2553 para 2.83
[17] CAA CAP2394 para 2.100
[18] CAA CAP2394 para 2.102

5.3. We believe that whilst NERL took certain cost mitigating actions during the pandemic, it could have been more efficient in its efforts to reduce its costs in response to the various stages of the pandemic.

5.4. The assessment by Steer of staff wage savings is limited to the extension across staff categories of a 10% pay cut for three months of 2020 with only a 50% acceptance rate[19]. It is our belief that whilst this represents a reasonable action for a business in NERL's position, it is in fact a limited one and that a number of airlines have demonstrated greater actions to reduce staff costs when faced with comparable circumstances[20] We believe NERL could have taken similar actions and that the CAA currently fails to appropriately address in its Provisional Decision.

5.5. The assessment of pay reductions is incomplete, with a lack of analysis for reducing furloughed staff wages from the 100% of pay level provided by NERL[21] to a level that was more reflective of the common actions across airlines in agreeing reduced wage levels for staff on furlough across the duration of the existence of the UK Government Job Retention Scheme. With some 1,829 employees furloughed at its peak, around 50% of NERL's workforce[22], this action could have a material impact on the efficient cost base during 2020-2022.

5.6. A number of airlines reached agreement to either limit furloughed staff wages to UK Government allowances[23] or at their discretion, top up furloughed staff wages to below 100% of pay[24] [25] notably to 80% of pay[26] [27], agreements that were strongly supported by union membership.

5.7. NERL itself apparently negotiated to recompense 122 Trainee Air Traffic Controllers ("TACTs") at 80% of salary whilst on furlough as a provision in providing fixed term contracts from December 2020 to March 2021 following their redundancy in November 2020.[28]

5.8. The reduction in staff wages for those on furlough is a fundamentally different action to the voluntary wage reduction assessment completed by Steer and we believe the assessment of NERL's furloughed staff wage costs and the disallowance of inefficient levels demonstrated by NERL in this regard is lacking from the CAA's determinations and needs to be addressed.

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[19] Steer report para 2.4.36
[20] Steer report figure 2.19
[21] Steer report para 2.4.32
[22] Steer report Table 2.5, p33
[23] https://prospect.org.uk/news/easyjet-refuses-to-bridge-furlough-salary-gap
[24] https://www.balpa.org/2020/07/31/ba-pilots-accept-jobs-deal/
[25] https://www.ft.com/content/5975cfb8-d692-497b-b1e3-cb5afdd0cfde
[26] https://www.unitetheunion.org/news-events/news/2020/april/unite-members-overwhelmingly-back-british-airways-furlough-deal/
[27] https://www.balpa.org/2020/07/01/ryanair-pilots-vote-to-accept-temporary-pay-cuts-to-protect-jobs/
[28] https://prospect.org.uk/news/nats-decision-to-retain-trainee-atcos-welcome-but-implementation-leaves-sour-taste

5.9. The allowance for NERL's Voluntary Redundancy programme appears to be calculated at an inflated level based on the adoption of a 12-month payback period in Steer's calculation, which is counter to evidence assessed by Steer that establishes a payback range of 54-75% of average wages and salaries in 2019 achieved by the comparator group[29]. Whilst the Steer applied payback level of 100% is greatly improved in relativity to the comparator levels than that delivered by NERL at 175%, we question the lack of justification for applying the level of 100% and why this is not lower reflective of the comparator group evidence.

5.10. Regarding the timing of the termination of NERL's pre-existing RRA, we question why it had not been terminated ahead of covid-19 as it was soon recognised by NERL as an area to be addressed with termination notice served in May 2020. NERL should have been conscious of its risk exposure presented in its industrial relations and should have been actively managing them in absence of the extreme pressure and necessity presented by covid-19 to ensure it was in an efficient and appropriate position to handle varying scales of redundancy scenarios or at minimum be positioned to complete timely renegotiation of standing agreements in scenarios of extreme variance.

5.11. The existence of NERL's RRA should not exclude the consideration of whether this in itself was an efficient action by NERL and the associated costs incurred as a result during the 2020-2022 to be allowed on the basis of the existence of the RRA.

5.12. If NERL was in a position to negotiate an exceptional RRA then it would be reasonable to consider it could have concluded agreement on an exceptional RRA at least by the end of September 2020 with evidence pointing to airlines negotiating new terms with highly unionised workforce elements by July[30] and September[31] that year.

5.13. It is our position that the redundancy scheme enacted by NERL was inefficient and demonstrated a significant lack of regard for the costs that will be borne by consumers as a result of its actions. The level of cost incurred and timeline of enactment demonstrated by airlines that operate in a competitive environment without the safeguard of economic regulation show a distinct enhancement to that which was achieved by NERL.

5.14. The CAA should reassess the level of costs disallowed associated to the redundancy programme to reflect a reduced payback period in line with those of assessed comparators by Steer, and for the enactment of an exemptional redundancy agreement from a sooner point in time in 2020.

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[29] Steer report para 2.4.30
[30] https://www.balpa.org/2020/07/31/ba-pilots-accept-jobs-deal/
[31] https://www.balpa.org/2020/09/25/breakthrough-means-no-compulsory-redundancies-amongst-easyjet-pilots-following-huge-community-sacrifice/

6. NERL's costs; operating and capital expenditure

6.1. The CAA must only include efficient operating expenditure in the NR23 price control and ensure that NERL is appropriately incentivised to become more efficient over the course of the period, promoting consumer benefits and productivity comparative to that expected in a competitive market environment, fulfilling the CAA's duties as set out in TA00.

6.2. In developing its final performance plan the CAA should be consistent in its consideration of the latest evidence available.

6.3. Overall, we are largely supportive of the proposals put forward by the CAA but urge that the CAA ensures it has appropriately considered the evidence available, ensured complete investigation of areas and adopts the recommendations of its advisors in cases of conflicting, ambiguous or lacking evidence. To fail to do so risks establishing inappropriate allowances and failing to protect consumers interests.

Inflation

6.4. We recognise that appropriate regulatory mechanisms are in place to address differences between forecast and outturn inflation and we support the update of inflation forecasts reflected in the CAA's Provisional Decision and advocate that these should be updated with any further appropriate data and evidence available up to point of publication of Final Decision.

6.5. The CAA highlight that NERL has evidenced several significant elements of its costs are either directly linked to inflation[32] or where inflation context has a bearing on its negotiations, where NERL gave the example of its staff costs[33] [34].We would highlight that it is for NERL to manage its costs, including supplier and staff expectations. The incorporation of inflation indexes to 40% of contracts and the basis of recent staff cost negotiations on 2022 inflation infer an acceptance of inflationary adjustments and a lack of incentive to appropriately remove or reduce such basis.

6.6. We note that other regulators have taken issue with airports trying to pass on the entirety of inflationary pressures. Indeed, the French Transport Regulatory Authority (ART) recently disallowed Nice airport's proposal to pass on the full inflation impacts in its charges as this would be incompatible with a competitive market where increases in charges are not fully passed on to consumers. The ART highlighted that airlines have been able to defer on the price of tickets the increases they suffer due to inflation and that Nice airport could not pass on all of its cost increases from inflation to end users in the long term[35].

[32] CAA CAP2553 para 4.16
[33] CAA CAP2553 para 4.57
[34] CAA CAP2553 para 4.15
[35] https://www.autorite-transports.fr/wp-content/uploads/2022/08/decision2022-058_vnc.pdf para 77

6.7. We therefore ask the CAA to verify whether it is appropriately incentivises NERL over time to only incur the level of costs that are necessary for the provision of the level of service required at a cost no higher than needs to be to consumers.

6.8. We question the assessments made by the CAA in determining the appropriate level of inflation of costs and the appearance of an over reliance on information from the regulated entity, provided at a high level[36], with limited benchmarking to comparators.

Staff Costs

6.9. We believe the CAA should set allowances reflective of the efficient levels required and those that would be required by an entity operating in a competitive environment; it is for the regulated entity to decide upon its own actions and how it wishes to operate its business within the allowances established by the price control and benefit from the productivity gains it could achieve.

6.10. Wages should represent the efficient level required to attract the required levels of talent without over-rewarding in excess of market rates. The CAA recognise difficulty in benchmarking based on the available data that has been reviewed[37] and as such we would advocate for the CAA to expand and refine its evidence base ahead of its Final Decision to ensure it has appropriately justified those costs considering their significant contribution to NERL's Determined Costs.

6.11. Steer's assessment that a 1.5% improvement in ATCO productivity could be achieved by NERL does not seem unreasonable considering the historic improvements achieved by NERL, its European top-5 comparators, combined with the historic traffic growth, the NR23 investment plan and in consideration of the March 2023 traffic forecast and growth levels above 2019.

6.12. Steer highlights a number of areas where improvements could generate productivity gains, including improvements in controller tools and other technology, increasing controller skills and experience, changes in airspace structures and by changes in the organisation, and coordination of controller with the available technology.[38] It is our understanding that these are all areas set for development in NR23 through what has been outlined in NERL's business plan.

6.13. We support NERL's objectives for its graduate programme but believe that the CAA's adjustment in its Initial Proposals to the allowance for graduate headcount seems reasonable on the basis that NERL's retention rate appears too pessimistic and the that the number of roles required "significantly exceeds rates of attrition modelled within the business"[39]. In our response to the CAA's Initial Proposal we highlighted that The Institute of Student Employers identify an average graduate

[36] CAA CAP2553 para 4.24
[37] CAA CAP2553 para 4.74
[38] Steer report p44
[39] CAP2394 p100

retention rate three years after the point of joining that is consistent with Steers assumption of circa 75%[40].

6.14. In adjusting its position on Graduate headcount, it appears that the CAA is disregarding the evidence of its own advisors in the face of lacking suitable evidence from the regulated entity. The CAA note that the evidence provided by NERL does not allow it to form a clear understanding of the assumptions of staff attrition and graduate retention rates contained in NERL's Business Plan or to enable verification of Steers assumptions in its assessments. In such situation it would appear inappropriate to adopt the position of the regulated entity and we urge the CAA to reconsider its proposal and to revert to its Initial Proposals in adopt the findings of its own advisors, Steer.

Pension Costs

6.15. British Airways are generally supportive of the actions the CAA has proposed to make regarding Pension costs. Pension costs represent roughly 20% of NERL's total operating costs; with NERL's Business Plan expecting them to increase through the course of NR23 by some 17%. Ensuring that such a high proportion of the cost base is reasonable and efficient should be a major focus of the NR23 process.

6.16. Although the DB scheme enjoys considerable protections, enshrined at the time of the public–private partnership, it is our view that NERL has failed to tackle the increasing costs of remaining elements of their pension scheme over recent years.

6.17. The generosity of the current DC scheme has long been pointed out by both airlines and CAA-appointed consultants. Despite calls over many years now for NERL to introduce a new, less-generous, DC scheme for new starters from their customers NERL has failed to tackle this issue. We strongly support the proposal to introduce a new DC scheme allowance for new joiners to be effective at the soonest opportunity.

6.18. British Airways supports the CAA's finding that "there is evidence that the contribution rate for the DC scheme, in particular for new hires, could reasonably be reduced without putting NERL in a disadvantageous position relative to comparator organisations in terms of attracting staff"[41].

6.19. In our response to the CAA's Initial Proposals, we questioned why the CAA has assumed a DC contribution rate of 12% on average, when GAD highlight FTSE100 companies provide contributions of 11% of pensionable pay and Steer's study for Eurocontrol suggested the average across their industry sample was 9%.[42]

6.20. We again point to the GAD report of FTSE100 companies provisions and promote that this forms the most appropriate and representative peer group for

[40] Steer report para 2.5.34
[41] Paragraph 4.74 of CAP2394
[42] Section 1.28 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

consideration, presenting a reflective sample of UK companies and market requirements for the attraction and retention of employees in large UK listed companies.

6.21. It is our opinion that the Steer assessment of five transport, utilities and logistics comparators is too restricted in size to be deemed reflective of market conditions and is further skewed away from forming a representative comparator due to the inclusion of two economically regulated entities within the peer group. As result of these factors the Steer group should be considered as failing to form a valid comparator.

6.22. It appears inconsistent that the CAA has decided not to adopt pay benchmarking against UK transport comparators and yet pursues such a comparator basis for its proposals of new entrant DC scheme employer contribution rates.

6.23. Determining to allow for a maximum NERL DC pension contribution rate of 11% of pensionable pay for new joiners, post 2023, will furthermore allow for a cost that is benchmarked as efficient from a FTSE100 benchmark.

6.24. British Airways welcomes GAD's expert technical analysis and their advice. GAD observe that "NERL's projected pension costs included within the Business Plan dated 7 February 2022 fall towards the upper bound of what GAD consider to be a reasonable and efficient range of pension costs for the NR23 price control period."[43] We are therefore keen to ensure that CAA is acting on the full range of various opportunities and recommendations identified that would seek to reduce the cost borne by airspace users and consumers.

6.25. GAD identifying that, based on NERL's business plan, that there is a risk that a trapped surplus could be expected to emerge in 2025, is useful. They further identify that, subject to legal clarification, there is the long-term likelihood that NERL cannot access any surplus until the pension scheme is wound up. GAD also say that they would expect the use to which any surplus is put to have regard to the best interests of consumers. GAD identify that they have indications that the pension scheme trustees might prioritise "de-risking the investment strategy"[44] "rather than passing savings onto consumers."

6.26. As a minimum we would encourage the CAA to ensure that NERL discuss with the Trustee's an "overfunding mechanism" / "switch off" mechanism to ensure that 'unnecessary' contributions are not paid and passed through to carriers and/or (as an alternative) to use an Escrow account, so that while contributions would continue, they would be earmarked for the scheme if a future valuation shows a deficit again, or if there is still a surplus it would be passed back to NATS for the benefit of airspace users.

[43] Paragraph 1.35 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[44] Paragraph 4.8 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

6.27. Given the already very high costs of funding the DB scheme, alongside the added costs of recovering the COVID related costs, which are causing the unit rate to increase significantly, British Airways favours the CAA seeking to determine a settlement that reduces the likelihood of that occurrence and favours the reduction of these costs passed on to NERL's customers in the initial instance during NR23.

6.28. The lack of certainty as to how the trustees would manage any trapped surplus and the indications that they would be minded to prioritise de-risking the investment strategy would mean that any trapped surplus would not result in an assured reduced cost of airspace users at a time when the costs of operations are already significantly increasing.

6.29. British Airways agrees with GAD's suggestion that "The CAA could consider the merits of approaches used by other regulators to incentivise their regulated companies to manage their pension schemes more effectively."[45] Again this issue does not seem to make it into CAP2553 and British Airways would like to understand the CAA's decision to exclude considerations in this area.

6.30. GAD identifies that the administration costs of the pension scheme represent approximately 2% of the NATS section pension costs (as included in the Business Plan). Whilst previous stewardship tests have sought to justify these costs, which are "higher than average according to data published by The Pensions Regulator",[46] the underlying historic justification of the level of administrative charges seem to have fallen away. We are left with a situation whereby the pension scheme administration costs, on a per member basis, at NERL are c.£360, which compares unfavourably to the average cost incurred by schemes with 1,000-4,999 members of £145 and even less favourably to the £70 cost for schemes with 5,000+ members. NERL has approximately 6,000 members.

6.31. It appears that the CAA should conduct a review of the latest stewardship report with a view to contenting itself that the administration cost, which are a minimum of more than double that of comparator schemes could be considered efficient. The CAA should also provide guidance as to its expectations in relation to reasonable administration costs to NERL.

6.32. GAD identifies the most significant assumption underlying the pension costs in NERL's business plan as being those relating to the discount rate. They say that "Considering the NATS Section's investment strategy, strong employers covenant and relative immaturity, we would expect the that the funding strategy would be broadly between the 70th and 95th percentile of Defined Benefit pensions schemes". The current discount rate is broadly 75th percentile. British Airways is therefore supportive of the CAA identifying that its "consider that there may be opportunities for future DB pension scheme valuations to include assumptions about the discount rate closer to the GAD mid bound, reflecting assumptions which are more consistent with the 85th percentile of DB pension schemes."

[45] Paragraph 4.33 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[46] Paragraph 7.1 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

6.33. GAD also identify that there is scope for consideration of a slowing down in the assumptions associated with the transition to the long-term funding strategy. They suggest that "CAA may also wish to consider whether further guidance on their expectations from NERL in further negotiations on appropriate time-horizons for transitioning to the long-term funding target would be useful. This may aid NERL at future valuations (such as the valuation due no later than 31 December 2023)."[47]

6.34. As stated previously, British Airways acknowledges and welcomes that the CAA's proposals on pensions costs remove a significant cost for airspace users when compared to NERL's business plan. We are however very mindful of how determinations in this area quite often end up obligating customers to fund costs for decades. Opportunities identified and presenting at this time to reduce the costs of pension provision need to be fully and carefully considered. The final NR23 determination must ensure that only reasonable and efficent funding of the pension scheme is allowed.

Non-staff opex

6.35. We welcome and endorse the CAA's updated proposals to determine NERL's non-staff opex levels, including its considerations towards DB pension management costs and the development of a new charging mechanism for new users which capture the costs associated with the development and integration of new users. We do not support the subsidy of new users by existing, conventional users and judge the CAA's proposal to be appropriate for UTM development costs to be borne by new users.

Capex

6.36. Significant changes to NERL's capex plan contained in its SIP have been made following publication of NERL's Business Plan which was assessed by the CAA and its consultants, Steer, as part of its Initial Proposals.

6.37. We support the overarching objectives of the plan, particularly in regards to upgrading technology systems in the critical and overdue pursuit of "legacy escape" and progressing airspace modernisation whilst sustaining systems and infrastructure to provide the necessary level of resilience.

6.38. We have concerns regarding the revision of costs and timelines to the NR23 capex plan, with significant rephasing and cost increases in the DP En Route programme being managed within a fixed capex envelope and are disappointed that NERL has not provided better quality of information, both in its engagement with customers and furthermore to the CAA[48]. Our concerns extend to the associated impact from

[47] Paragraph 6.23 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc"
[48] CAA CAP2553 para 4.174

these changes to the Common Platform programme with the appearance of deferring significant costs and benefits into NR28 or beyond.

6.39. We support the appointment of Egis to conduct a review of NERL's NR23 capex plan to assess the robustness of NERL's approach in revising the programmes in 2022, extent of efficiency and deliverability of the plan and the extent to which it delivers benefits furthering the interest of customers and consumers[49].

6.40. We suggest NERL should provide the adequate information required to justify the reallocation of £15m of capex to opex relating to IT service capitalisation changes. The CAA should consider if there are unintended consequences to the incentives in doing so.

6.41. We support the strengthening of the capex engagement incentive for NR23 and support the CAA's proposal for consultation during NR23 on the consideration of greater capex monitoring and, or strengthened capex delivery incentives.

7. Financial Framework

<u>RAB</u>

7.1. We support NERL being compensated only for efficient financing and efficient investment of Capex in order to maintain safe and resilient activities, subject to the risk as assessed by the WACC.

7.2. We continue to advocate the introduction of CPI indexation of the RAB for NR23. We would prefer this move was made for NR23 but understand that the CAA will look at this again in NR28 which is not consistent with changes that have been made elsewhere in the price control. With TRS cost recoveries from 2020-2022 to extend beyond 2030, representing the withdrawal of the RPI measure of inflation indexation, the tail end of these adjustments will be in error by being based upon inconsistent inflation indices.

7.3. It will be our clear view that that RPI indexation cannot continue into NR28.

7.4. The separation of the TRS recoveries from 2020 to 2022, to form a separate line in the RAB is supported to provide distinction of these amounts from the remainder of the RAB representing a log of efficiently incurred capital expenditure and will provide greater transparency.

<u>Regulatory Depreciation</u>

7.5. We are supportive the CAA's proposal to retain the RP3 approach taken to estimate regulatory depreciation as set out in paragraph 5.26 of CAP2394, noting that this approach was supported by the CMA at the time of their review.

[49] CAA CAP2553 para 4.164

Tax

7.6. We support the CAA's proposal to set out an explicit tax allowance or revenue building block in its calculations of NERL's price control revenue rather than applying an uplift to Vanilla WACC which is more difficult to reconcile. We note the observation that this change in approach to calculating tax allowance has no disadvantage to that used in RP3. That assurance, and knowledge that this change follows in the footsteps of determinations made by regulators, such as Ofwat and Ofgem, in other industries provides comfort that this approach should work.

7.7. We are supportive of the measures proposed to increase the transparency of tax liabilities (versus RP3) and welcome the CAA's efforts to ensure that only efficient tax based on known inputs such as the corporation tax rates and efficient use of capital allowances and notional deductions such as interest payments are accounted for.

WACC

7.8. We advocate that the CAA continues to assess and adopt the latest available data and evidence to update the WACC allowance up to the point of publishing its Final Determination.

7.9. We support the continued consideration of a notional gearing assumption for NERL when estimating the WACC. As the CAA identify, this is a well-established approach with significant regulatory precedent across other UK economic regulators.

7.10. We continue however to have concerns over the approach employed by the CAA and Flint and re-reiterate our concerns expressed in our response to the IPs, notably on the calculation of the asset beta. We note the following concerns with Flint's updated beta assessment and attach a note at the end of our response detailing some of those concerns further:

7.10.1. **Pandemic uplift**: We continue to strongly disagree with the pandemic uplift applied to the asset beta. We believe that observed beta values already reflect the atypical shocks of the COVID pandemic and therefore adjustments are not necessary.

7.10.2. Indeed, in an April 2023 report on the asset beta for French airports (including ADP, which Flint uses as a comparator for NERL), the French Transport Regulatory Authority (ART) found that potential adjustments to the beta are premised on assumptions on the duration of the pandemic and on the frequency of similar events in the future that may appear arbitrary[50]. This inherent difficulty is demonstrated by Flint's subsequent revision to its assumptions for the duration of the pandemic shown below. We note that

[50] See ART report, paragraphs 131-132, available at 2023-04-17-cmpc-aeroportuaire-consultation-publique_v-post-college_clean.pdf (autorite-transports.fr)

the ART proposed not to make any adjustments to the beta for the Covid pandemic, while the consultant it commissioned found that "*it does not seem inappropriate to take into account all the observations of the period (including atypical returns), which ensures regulatory continuity and avoids introducing unjustified complexity*".[51]

7.10.3. **Double counting of pandemic beta**: As noted above, the inclusion of a pandemic adjustment does not account for the fact that investors will not ignore the systematic risk from major shock events in the future. In fact, post-COVID data will reflect the forward-looking view of all risks, not a baseline beta that assumes no COVID risk. By assuming post-COVID data comprise a baseline beta and an additional adjustment, the CAA is double counting.

7.10.4. **Pandemic duration**: Flint now recognises that November 2020 was the last major COVID-linked event with a distortive impact on data, which would limit the assumed pandemic duration to 9 months from the onset of the pandemic – down from a previously estimated duration of 26 to 39 months. For consistency, and notwithstanding our position on the pandemic uplift above, this reduction should be reflected in the beta pandemic adjustment.

7.10.5. **Inclusion of ENAV in the peer group**: Flint recognises that ENAV's beta estimates are less statistically reliable, with wider confidence intervals, and acknowledges that it has found it particularly challenging to calculate a pre- and post-pandemic asset beta. Nevertheless, the CAA has not justified why it considers appropriate to continue including ENAV in the peer group (Flint has for instance excluded Vienna airport for data reliability reasons) or whether ENAV's atypical post-pandemic observed values could be justified for reasons such as ENAV's share being thinly traded or due to its non-regulated activities being exposed to a higher systematic risk.

Despite ENAV being the only publicly traded ANSP, we consider that the reasons above are sufficient to exclude it from the peer group or at the very least reduce its weight in the calculation of the comparator beta.

Notwithstanding the above, we note that the CAA has retained an artificially high beta for ENAV of 0.70. This is 0.04 higher than would be the case of using the baseline beta of 0.62 and the Flint's (lower) ENAV COVID adjustment of 0.01-0.04.

7.10.6. **Different risk profile of comparator airports**: Besides basing the analysis on the peer group proposed by the CMA in the RP3 reference, we do not believe that the CAA or Flint have addressed why the airports retained in the peer group are comparable to NERL. In fact, we consider that these airport groups are subject to different regulatory regimes and have

[51] *Ibid*.

significant non-regulated activities exposed to a higher systematic risk, necessitating downward revisions to their observed betas.

Indeed, all airport groups (AENA, ADP, Fraport) operate airports in Europe subject to a dual or hybrid till regulatory regimes, operating (riskier) commercial activities sitting outside the regulated perimeter. Similarly, both ADP group and Fraport group operate airports in jurisdictions outside Europe, such as Asia, South America, the USA and Africa, while AENA operates a network of 47 airports in Spain – including small regional airports with higher exposure to traffic risk. These factors demonstrate different risk profiles to NERL and we consider that CAA/Flint should revise the beta to reflect the lower risk faced by NERL's regulated activities compared to those entities.

8. Charges and Financeability

8.1. The CAA considers NERL's financeability within its secondary duties and we support the assertion that NERL should retain access to financial markets on reasonable terms, as required within NERL's licence for it to ensure that it maintains an investment grade issuer credit rating[52]. This should benefit customers and consumers through reduced financing costs and be reflected in NERL's WACC calculation.

8.2. The building block allowances are a critical component in establishing NERL's determined costs and we believe that it is appropriate for elements within these building blocks are adjusted by the CAA in its development of its final performance plan. We also advocate for the adoption of the latest information available to the CAA, including the update of traffic forecasts. As such we expect these adjustments to be accounted for in updated determined costs in the final performance plan.

8.3. In addition to recovering its determined costs, there are significant TRS revenues to be recovered from 2020 to 2022. We consider that it is reasonable to recover these revenues over 10 years, split evenly between NR23 and NR28. Reducing the repayment period or increasing the weighting of recoveries in NR23 would put further considerable upward pressures on affordability as airlines continue to recover from the impacts of covid-19 and consumers face a level of uncertainty in the economic outlook.

8.4. We agree that there is a strong argument for smoothing the impact of the covid TRS recoveries to support affordability in the early years of the price control and it appears reasonable to adopt a flat real term profile of charges in NR23.

8.5. We note that the CAA maintained the 2023 unit rate based on its Initial Proposals and has accounted for the difference to its Provisional Decision updated Determined Costs for 2023 in the remainder of NR23. Greater visibility and clarity within the

[52] NERL's licence, Condition 5, para 23

Final Decision of the treatment of this variance would be appreciated to enhance transparency for users.

9. Regulatory Incentives and mechanisms

9.1. Basing the traffic risk sharing mechanism on the default mechanism included in the EU charging rules for RP3 provides a largely consistent approach to previous price controls but should also be tailored to reflect NERL's particular business and ability to adjust its cost base to short term and sustained variations in traffic.

9.2. Dead bands should only be allowed if they are logical, based upon the operating leverage in the business and in particular avoiding incentive issues where sharing rates change dramatically.

9.3. We agree with NERL that it is "in users' interests to seek to avoid sharp increases in prices following major shocks to the aviation sector, while recognising that a clear and secure regulatory policy on the ultimate recovery of allowed revenues is vital to underpin the efficient long-term financing of the ANSPs"[53] and welcome the concept of smoothing the costs of any significant traffic downturn through the spread of recoveries over an n+3 and n+4 basis for traffic depression versus forecast of over 10%.

9.4. Further refinement of the CAA's proposed adjustments to the TRS could be appropriate for such a scenario with consideration toward consecutive years with outturn traffic satisfying this criteria which would compound the recoveries to be made from users in the fourth year after the initial depressed year which could create unaffordable upward pressures on unit rates in a time of potential traffic recovery.

9.5. We do not support the introduction of a TRS mechanism to Oceanic traffic. A significant portion of the Oceanic service is already protected from traffic risk through NERL's contractual arrangements with Aireon. There would need to be a clear and proportionately substantial benefit to consumers to justify the additional complexity.

9.6. We support the CAA's assessment that there is no requirement for the inclusion of adjustments for asymmetric risks.

Airspace modernisation

9.7. We fully support the appropriate provision to enable the efficient delivery of airspace modernisation including the allowances and governance proposals set out by the CAA in its Provisional Decision.

New Users

[53] https://i.nats.aero/pubdocs/doc/appendix-i-determined-costs-ducs-and-prices/ p10

9.8. There is a high degree of uncertainty towards the services and infrastructure required by new users during NR23 and further into the future in NR28. We support the CAA's proposals and consider that they address concerns regarding the existing user pays principle that had arisen from NERL's proposed approach and the risk of cross subsidy.

Capex engagement incentive

9.9. Whilst the capex engagement incentive is relatively new, having been introduced in 2021, the CAA and independent reviewer have learned a significant amount about the practical operation of the incentive in that time. Trusting in the practical experience that has been gained, as well as considering the 2+5 capex planning approach adopted by NERL that heighten the requirement for quality engagement, we support the adjustments proposed.

10. London Approach and Oceanic

10.1. We are supportive of the CAA's proposal to retain a stable regulatory framework that is a relatively simple, straightforward and proportionate approach to regulating these charges.

10.2. British Airways supports keeping the cost allocation unchanged and support the CAA's proposal that "the cost allocation for London Approach in RP3 should be retained for NR23".[54]

10.3. We advocate for regulatory consistency, following the RP3 precedent with aligned TRS mechanism between En Route and London Approach, and for the adoption of arrangements from En Route to be applied for London Approach in regard to both the NR23 TRS mechanism and 2020-2022 TRS debtor recoveries.

10.4. We support the CAA's proposal to retain the requirement on NERL to report on its London Approach delay performance and do not currently seek to make a case for the introduction of financial incentives on London Approach delay.

10.5. We note that Oceanic forecasts have been updated, adopting inputs from the STATFOR March 2023. Given the Oceanic forecast is calculated by NERL as an independent forecast is unavailable, the forecast and its calculations should be disclosed to users for transparency and to appropriately enable their assessment.

10.6. We support the CAA's calculation of Oceanic costs and the adoption of the latest traffic and inflation forecasts, as well as reflecting its proposals across En Route building blocks, in calculating its Oceanic allowances. We advocate for the CAA to consider and adopt any credible updates to data and evidence in establishing its Final Decision, including for ADS-B costs consideration of USD:GBP exchange rates.

[54] Paragraph 8.18 CAP2394a

10.7. We support the undertaking of the ADS-B review and for the consideration of updating the regulatory allowance and any efficiency adjustments for ADS-B as established in the CMA RP3 review.

10.8. We support the maintained proposal not to include a TRS mechanism on the Oceanic service.

10.9. We do not support NERL's considerations of extended Oceanic flight times to be appropriate given that the observations are based on data in the 12 months to July 2022, representing a significantly outdated period and one that was severely impacted through covid-19.

We welcome further engagement as the CAA refines its proposals prior to publishing its Final Performance Plan.

Yours sincerely,

Rory Lillington
Economic Regulation Executive
Networks & Alliances
British Airways Plc

Appendix A to British Airways response to CAP2553: Cost of capital

Rather than reiterate previous points (which still stand), in this response, we focus on areas where the CAA and its adviser on beta, Flint Global ('Flint'), have provided updated analysis or changed the approach since the NR23 Initial Proposals (CAP2394).

In addition to the concerns on the calculation of the asset beta raised in our main response, we focus in this appendix on three important errors we consider the CAA has made in estimating the cost of capital. Each identified error relates to beta estimation and in combination the effect is material:

1. Retention of a 26-39 month assumed pandemic duration on beta is no longer consistent with CAA and Flint evidence on the COVID-19 pandemic.
2. An upwards bias exists in the asset beta range due to inconsistent inclusion of ENAV data.
3. The CAA and Flint has misinterpreted post-covid beta evidence for comparators.

We also discuss the CAA's proposed approach of translating the CMA's H7 Heathrow appeal Final Determination into the NR23 Final Decision, with potential read across on the cost of capital[55].

New errors in cost of capital estimation

Error 1: CAA/ Flint now adopt a shorter duration of COVID impacts, but fail to update beta estimates to align with that

At NR23 Initial Proposals (IPs), Flint estimated two components within beta – a baseline beta and a COVID adjustment. Flint assumed a 0.02-0.11 uplift to a baseline beta estimates for the COVID adjustment, based on:

- An empirical estimate of higher betas during COVID-impacted time periods for comparator betas.
- An assumed pandemic frequency of 1 in 20yrs to 1 in 50yrs.
- An assumed pandemic duration of 26 to 39 months.

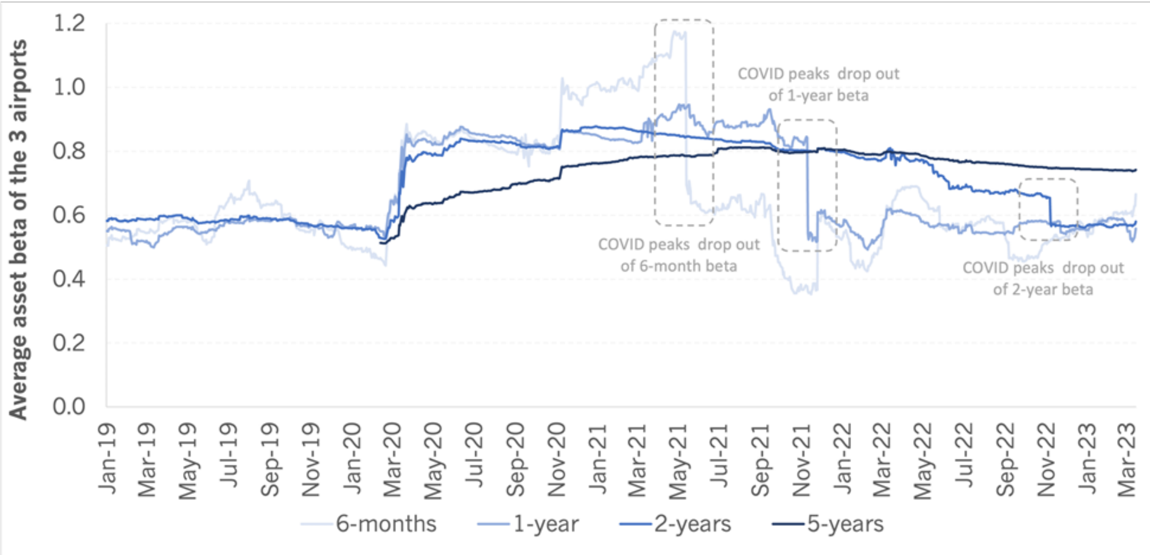
In their updated April 2023 report, Flint use a shorter period of COVID-impacted data than at NR23 IPs[56]. The new data led to the COVID adjustment being revised down to 0.02-0.08.

Flint now recognise the evidence that shows that November 2020 was the last major COVID-linked event that had a distortive impact on beta. November 2020 is 9 months after the COVID pandemic began to have an impact on comparator asset betas. However, neither Flint nor the CAA have revised the pandemic duration down from 26 to 39 months[57].

[55] The CAA has indicated that the CMA's H7 Provisional Determination is expected in early September 2023, with a Final Determination due by 17 October 2023.
[56] The COVID impacted data cut-off was revised to end-December 2021. This is 22 months after the start of the COVID pandemic's impact on beta – below the CAA's lower bound of 26 months.
[57] Neither the CAA nor Flint refer to the assumed pandemic duration of 26 to 39 months.

Flint's (2023) Figure 4, shown below, clearly demonstrates that the assumed pandemic duration directly reflects the estimation window chosen.

FIGURE 4: DAILY ASSET BETAS FOR THREE-AIRPORT COMPARATOR SET OVER DIFFERENT ESTIMATION WINDOWS



Note: 3 airports include AENA, ADP and Fraport. Betas are estimated against the STOXX 600 and assume a debt beta of 0.05. Gearing is interpolated from Thomson Reuters reported net debt.
Source: Flint analysis based on Thomson Reuters data as of 15 March 2023.

It is the November 2020 vaccine news (and share price movements) that influenced beta, by distorting beta estimates where this data remains in the sample. We can see this impact as the beta estimate falls in May 2021 with a six-month beta, falls in November 2021 with the 1-year beta, and falls in November 2022 with the 2-year beta. The empirical beta estimate will fall in November 2025 with the 5-year beta. A 10-year beta (not shown) will exhibit a fall in November 2030 when the vaccine news data point drops out of the sample. We have previously highlighted how powerful shock events are in a pooled sample. The CAA/ Flint have failed to identify the last data point where COVID actually had a material impact on beta.

We consider that the assumed duration should be set to 9 months for both lower and upper bound, based on Flint's own analysis to reflect the period February to November 2020.

As the pandemic duration acts as a linear scalar to the assumed COVID adjustment, a reduction from 39 months to 9 months, all else being equal:

- reduces the upper bound of the COVID adjustment from 0.08 to 0.02; and
- reduces the lower bound of the COVID adjustment from 0.02 to 0.00[58].

We recommend the CAA follow through on its acknowledgement of a shorter period of impact. The mid-point of the COVID adjustment range falls by from 0.05 to 0.01. This reduces the mid-point of the overall asset beta range from 0.61 to 0.57, prior to correction of other identified errors.

58 To two decimal places.

Error 2: The CAA/ Flint apply inconsistent measures to artificially inflate the inferred asset beta

It is common ground that ENAV data is difficult to interpret but the only other listed ANSP, there is an inclination to place some weight on this data. The CAA and Flint both highlight that the data is volatile and movements are inconsistent with a qualitative assessment of systematic risk, so it follows that placing weight on this data risks the drawing of inappropriate conclusions.

Flint's analysis identifies a preferred baseline beta of 0.55 for the three airport comparator set (i.e. excluding ENAV), with empirical asset beta data in the range 0.49-0.57. If we add the assumed COVID adjustment of 0.02-0.08, we get to a weighted asset beta of 0.51-0.65 for the airline comparators.

Flint estimate ENAV's baseline beta at 0.62. The 0.08 three-airport adjustment is used to get to an upper bound of 0.70, despite Flint's estimate of ENAV's COVID adjustment being lower (0.01-0.04). Using the ENAV adjustment with ENAV baseline beta would imply an upper bound asset beta of 0.66 (i.e. 0.62 + 0.04).

The upper bound asset beta of 0.70 used by Flint and the CAA is 0.04 higher than would be the case from using consistent data for the baseline beta and COVID adjustment. Consequently, we do not consider the CAA/Flint analysis to be credible[59].

Error 3: The CAA/ Flint 'double count' through incorrectly interpreting post-COVID data as 'baseline beta'

ENAV's baseline beta is comprised of both the pre-covid and post-covid data identified by Flint. The inclusion of post-covid evidence pushes this baseline view of NERL's asset beta to 0.62, driven by ENAV data.

Flint states that "*Our baseline beta is intended to reflect the systematic risk faced if an event like COVID-19 were never to happen again.*" This is inconsistent with the evidence used.

If the CAA is right that a similar pandemic occurs once every 20-50 years, investors will not ignore systematic risk from such major shock events. The post-COVID data will reflect the forward-looking view of all risks, not a baseline beta that assumes no COVID risk. By assuming post-COVID data reflects a baseline beta and then applying a 0.02-0.08 on top of this, the CAA/ Flint are double-counting and incorrectly inflating their beta estimate.

Post-COVID data can be powerful as a cross-check for the CAA/ Flint's overall asset beta estimate. If the data was used properly for this purpose, the CAA/ Flint would see that their asset beta estimate is biased upwards by methodological errors.

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[59] If the decision is driven by the CMA's RP3 decision, we consider this an error. The CMA determination was not finalised and was distorted by COVID-impacted data. We consider that the additional thinking and visibility of data since early 2020 allows a clearer view on a baseline beta.

Translation of CMA H7 provisional and final determinations for NR23

The CAA has indicated that the CMA H7 Heathrow appeals outcome will inform the position adopted for the NR23 Final Decision. If the CAA has adopted an identical position for NR23 as at H7 and the CMA finds that the H7 position was in error, we support the principle of making the equivalent change for the NR23 Final Decision.

However, we highlight three challenges for the CAA in interpreting CMA findings on H7:

- Interpreting CMA decisions in the separate context of NR23.
- Suitable timing for engaging with stakeholders.
- Correcting issues not identified by the CMA as errors in the H7 appeals.

For interpreting CMA decisions, it would be wrong for the CAA to simply lift quantitative CMA H7 asset beta estimates and use these for NR23. The appropriate approach will reflect the principles set out by the CMA and consider the different contexts for H7 and NR23. To achieve this, we would support timely engagement with stakeholders, to discuss whether and how it is appropriate to reflect CMA positions.

On timing, we consider that engaging immediately following the CMA's provisional determination would be most suitable (if publication allows), rather than waiting an additional six weeks to receive the CMA's final determination.

The final point to highlight is that the CAA may have been challenged on a particular item at H7 and the CMA may not find this to be erroneous. This does not automatically mean that there is a case for adopting the same position at NR23 – for example, if more information is now available.

The CAA should therefore be willing to make changes to reflect new evidence, even if not prompted to do so by the CMA. An example could be on the first error we identified on beta – the CAA and Flint have now clearly demonstrated that the 26 to 39 month duration assumption would be unreasonable, even if the CAA were to find that the CAA's position at H7 was not erroneous based on information available at the time.