Oceanic Industry Seminar

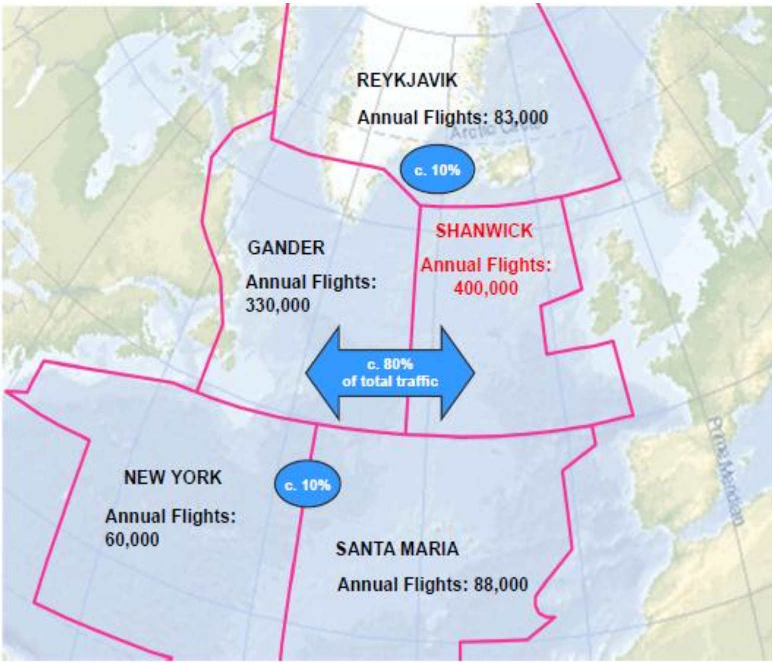
1 September 2014
CAA House, London

Background

Background

Shanwick Oceanic service provided by UK and Ireland under mandate from ICAO

- High seas – not covered by EU competency
- NERL provides ATS service (IAA provides communications)
  - Charge control only on NERL component
- Procedural service (no radar) designed around organised track system
- Strategic and tactical cooperation with Nav Canada (80% of North Atlantic through both Shanwick and Gander)
- Small part NERL business (c4% revenue, 3% RAB)



Charges regulated since PPP by a very simple RPI-X formula on the charge per flight. Given small scale of business, simplicity seen as a virtue.

Process so far

- Oceanic is currently price regulated by a condition in the NERL licence.
- The current licence condition would run to 31 march 2015.
- Process to review licence condition has run alongside the SES performance process (to minimise burden but separate from it.)

NERL publishes Initial Business Plan	May 2013
Customer Consultation Oceanic Workshop	May-September 2013 3 July
NERL publishes Revised Business Plan	October 2013
Eurocontrol/IMF updates to traffic and inflation forecasts	Feb/April 2014
UK Ireland submit SES Performance Plan to CION/PRB	27 June 2014
CAA publishes Oceanic Consultation paper CAP1205	24 July 2014
Industry seminar	1 September 2014

Issues

Why Continue to Regulate?

- NERL has significant market power derived from the ICAO mandate
- Not clear if, or how, other measures to restrict abuse could be made to apply (process for moving ICAO mandate to other State)
- Cost of regulation can be kept low:
  - simplicity of price cap /processes and information
  - risks of stifling technological innovation mitigated by allowing modification if there is a proposition within the reference period supported by users

CAA proposes to maintain a very simple price cap in the NERL licence.

Basis of Proposals

- ***Maintain Simple Charges Cap***
  - Do not adopt a full SES style structure

- ***Align some of the features with SES to avoid complications of process***
  - Move to calendar year (consistent with SES)
  - Use CPI as measure of inflation
  - Correction of any under/over-recovery in year N+2

- ***Dealing with a technology shift during the control period***
  - Possibility to re-open the Oceanic price cap if NERL invests in new technology (satellite based surveillance and communications) given the business case is supported by users

RPI v CPI

- Current cap based on an RPI-Z specification
- For 2015-2019 the inflation factor applied in domestic airspace is based on CPI
- CAA is proposing to set a cap CPI-Z* equivalent to what it would have been if specified as RPI-Z (i.e. the difference between RPI and CPI counterbalanced by the difference between Z-Z*)
- Difference between the anticipated and actual CPI-RPI variance, either positive or negative, should be relatively small

Questions

- Is it appropriate to continue to regulate Oceanic charges so long as that control is simple and easy to administer?
- Do you agree with the proposed form of regulation for Oceanic services? Mindful of the degree of market power, do you consider a different regulatory approach would be more proportionate given the scale of the business? If so, what would that approach comprise?
- Should the timeframe for an Oceanic charge control be aligned with the timeframe for the RP2 controls for Eurocontrol and terminal services?
- Should the basis of indexation of charges be changed from RPI to CPI (subject to the value of Z* in a CPI-Z* charge cap being expected to generate the same amount as the value of Z in an RPI-Z cap)?
- Is the approach proposed by the CAA to revise the Oceanic charge cap where a technology shift occurs during the control period acceptable?

Figure 2.3 Summary of Oceanic CP3 performance v forecasts
Source: NERL regulatory accounts and CAA analysis

Civil Aviation Authority

Oceanic performance 2011-2014

Figure 2.3 and Appendix B did not incorporate adjustments made to regulatory accounts in following years - this is the corrected data

	2011/12	2012/13	2013/14
Traffic (actual) v forecast	+0.8%	-4.1%	-4.3%
Outturn return on RAB v forecast	6.7% v 5.4%	4.4% v 5.1%	4.2% v 5.7%
Total costs (actual) v forecast	-2.8%	-3.1%	-0.4%

	2011/12			2012/13			2013/14		
	Actual	CP3 projection	variance B/(W)	Actual	CP3 projection	variance B/(W)	Actual	CP3 projection	variance B/(W)
Flights	402.5	399.5	0.75%	393.3	410.2	-4.12%	402.8	421.1	-4.30%
Shanwick Oceanic Control Area charges	26.1	26.5	-0.4	25.8	26.9	-1.1	26.2	27.0	-0.8
Other revenue	0.6	0.6	0.0	0.6	0.6	0.0	0.6	0.6	0.0
Total revenue	26.7	27.1	-0.3	26.4	27.5	-1.1	26.8	27.6	-0.9
Operating Costs	13.8	14.5	0.7	14.1	14.8	0.7	14.6	14.8	0.2
Defined Benefit Pension Cash Cost	4.0	4.0	0.0	4.0	4.0	0.0	3.8	3.8	0.0
Depreciation	6.4	6.4	0.0	6.8	6.8	0.0	7.1	7.1	0.0
Total costs	24.2	24.9	0.7	24.8	25.6	0.7	25.5	25.6	0.2
Regulatory profit	2.6	2.2	0.4	1.6	1.9	-0.4	1.3	2.0	-0.7
Capitalised Financing Costs for the year	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Regulatory return	2.6	2.2	0.4	1.5	1.9	-0.4	1.3	2.0	-0.7
Average RAB	38.5	40.5	-2.0	34.6	37.9	-3.4	31.6	34.8	-3.2
Regulatory rate of return	6.67%	5.38%	1.29%	4.37%	5.07%	-0.70%	4.17%	5.73%	-1.56%

Projections for 2015-2019

CAA Proposals

Civil Aviation Authority

- ***Starting point: RBP produced by NERL following Customer Consultation Process.***
- ***Projections based on consistent view of traffic and cost assumptions as per the RP2 performance plan***
- ***Cost interventions equivalent to those applied to the RP2 plan***
- ***Proposal***
  - 2015 charge: £60.98 in 2012 prices (real reduction 1.25% on 2014)
  - 2016 to 2019: CPI -5%

Opex Interventions (1 of 2)

- Staff opex (excl. pensions)
  - adjust assumptions for average pay consistent with RP2
    - increases in average staff costs to the rate of CPI
    - No wage drift
- Pensions
  - 80% pass through where actual contributions > determined contributions
  - 100% pass through where actual contributions < determined contributions
  - reducing the contributions assumed for 2018 and 2019 by 10%
- Non-staff opex
  - adjustment to Employee Share Ownership Scheme consistent with RP2 (continue to make a cost allowance for the distribution of shares to employees at less than cost but does not make an allowance for the anticipated increase in the liability to eventually redeem shares generally)
  - remove opex contingency (c.£0.2m per year)

Opex (2 of 2)

Opex (excl. pensions)

2012 prices (£m)	2015	2016	2017	2018	2019
RBP	15.1	15.3	15.3	15.2	15.1
Proposal	15.0	15.0	15.0	14.8	14.7
Difference	-0.1	-0.3	-0.3	-0.4	-0.4

Cash pensions costs (DB and DC)

2012 prices (£m)	2015	2016	2017	2018	2019
RBP	3.3	3.3	3.4	3.4	3.3
Proposal	3.3	3.3	3.3	3.1	2.9
Difference	0.0	0.0	0.0	-0.3	-0.4

Capex

- CAA proposes to adopt the capital expenditure projections in the RBP in constant prices for the purposes of the RP2 price control, as:
  - There was significant support for the output of NERL's Oceanic plans during Customer Consultation,
  - CAA's consultants consider there is reasonable evidence to support a view that the RBP can be expected to offer value for money for users,
  - There is potential disbenefit to users should the programme be delayed

2012 prices (£m)	2015	2016	2017	2018	2019	Total
Capex	1.0	1.0	0.6	0.5	0.8	3.8

* CAA recognises that there may be circumstances where the opportunities to bring forward new technologies and the interests of users may lead the CAA to revise the price formula

RAB and Depreciation

Civil Aviation Authority

Regulatory Asset Base

- CY presentation is only illustrative

2012 prices (£m)	2015	2016	2017	2018	2019
Average RAB	28.6	25.7	22.7	19.9	17.2

Regulatory Depreciation

2012 prices (£m)	2015	2016	2017	2018	2019	Total
RBP	5.3	4.7	4.2	3.9	3.9	22.0
Proposal	5.3	4.7	4.2	4.0	3.9	22.1
Difference	0.0	0.0	0.0	0.0	0.0	0.0

Cost of Capital (1 of 2)

- CAA proposes to apply the same pre-tax cost of capital of 5.86% to Oceanic, as:
  - financing of NERL was conducted on a company-wide basis and it was therefore appropriate for the cost of capital to also be applied on the same basis,
  - the advice of CAA's consultants PwC was on a cost of capital for NERL rather than specifically directed at the Eurocontrol business,
  - a definitive analysis of a separate cost of capital for Oceanic would need to take account of the effective rate of tax,
  - no separate analysis was conducted for segments of the UKATS business which were not subject to the Eurocontrol cost sharing mechanism (e.g. the MoD contract),
  - the Oceanic business represents only a small segment of the NERL business,
  - in absolute terms the effect of a lower cost of capital on overall Oceanic costs would be small.

Cost of Capital (2 of 2)

Regulatory Return

2012 prices (£m)	2015	2016	2017	2018	2019	Total
RBP	2.0	1.8	1.6	1.4	1.2	7.8
Proposal	1.7	1.5	1.3	1.2	1.0	6.7
Difference	-0.3	-0.3	-0.2	-0.2	-0.2	-1.1

Change to Calendar Years

- Transitional costs
  - Bringing forward use of latest traffic forecast +£0.3m for NERL
  - Charges based on the lower RP2 cost base -£0.3m for NERL
    - Does not include bringing forward elimination of opex contingency
  - Oceanic charge for 2014/15 only being in place for nine months (75% of the year estimates that (due to traffic seasonality) approximately 78% of the full year traffic volume will be realised in 9 months) +£0.8m for NERL

*Likely to outweigh the advantage to NERL from 14/15 charge being in place for 9mo.

Profiling

- CAA sees merit in smoothing the evolution of charges, as:
  - the percentage rate of reduction after the first year would be equal in each year,
  - NERL would receive the present value of its costs over the course of RP2 in total over the period.

2012 prices	2014	2015	2016	2017	2018	2019	PV **
Un-profiled DUC	61.75	60.50	57.70	55.17	52.54	50.61	£102.7m
Expected profiled values	61.75	60.98*	57.98	55.14	52.44	49.87	£102.7m

Proposal summary and comparison to RBP

2012 prices	2015	2016	2017	2018	2019	Total
£million						
RBP (October 2013)	**25.4**	**24.7**	**24.1**	**23.6**	**23.2**	**121.0**
Opex (incl. removal of contingency)	-0.1	-0.3	-0.3	-0.4	-0.4	-3.3
Pensions	-0.0	-0.0	-0.0	-0.3	-0.4	
Regulatory Depreciation	0.0	0.0	0.0	0.0	0.0	
Regulatory Return	-0.3	-0.3	-0.2	-0.2	-0.2	
Total	-0.4	-0.5	-0.6	-0.9	-1.0	
CAA Proposal	**24.9**	**24.2**	**23.5**	**22.7**	**22.2**	**117.7**
£						
Profiled price	60.98	57.98	55.14	52.44	49.87	n/a
£million						
Average RAB	28.6	25.7	22.7	19.9	17.2	n/a

Questions

- Is it reasonable to apply assumptions consistent with those adopted in the UK-Ireland FAB Performance Plan for NERL's Eurocontrol business?
- Do you have any comments on the building block assumptions?
- Is it reasonable to apply profiling to arrive at a simple CPI-X charge control?

Next Steps

Process

- The process needs to allow a modification to the Oceanic Charge Condition in the NERL licence to take effect on 1 Jan 2015.
- An equivalent modification to the price condition for EUROCONTROL charges will also need to take effect on 1 Jan 2015.

Publish consultation	24 July
Industry Seminar	1 September10:00-12:00
Consultation Closes	25 September
Publish notice to modify licence	Mid October
Notice period closes	Mid November
Issue decision	Early/Mid December

Consultation responses

Consultation responses sent to:
NATSoceanic@caa.co.uk

by **25 September 2014**

If you wish to discuss any aspect of this document you may contact Mike Goodliffe at 020 7453 6226, mike.goodliffe@caa.co.uk or Anna Zalewska at 020 7453 6291, anna.zalewska@caa.co.uk

Oceanic Industry Seminar

1 September 2014, CAA House, London

Attendance:
Balmforth Louise (NATS)
Boase Emily (Prospect)
Buss Tony (BA)
Curran Peter (IATA)
Curtis Aaron (Prospect)
Elliott Simon (Thomson)
Fotherby Nigel (NATS)
Joseph David (Virgin)
McFie Bill (NATS)
Muir Alastair (NATS)
Rolfe Martin (NATS)
and
Gifford Stephen (CAA)
Goodliffe Mike (CAA)
Zalewska Anna (CAA)

Note of meeting:

1. The CAA presented an overview of its proposal for an Oceanic price control for 2015-2019.
2. The overview was divided into 3 parts: Background, Issues, and 2015-2019 Projections.
3. **Background:**
    a. The CAA noted the features of the Oceanic service. Shanwick Oceanic service is provided over the busy portion of the Eastern Atlantic Ocean. It is over the high seas and therefore is not currently covered by EU competency – the Single European Sky (SES) scheme. It is jointly provided by the UK and Ireland under a mandate from ICAO. NERL provides the air traffic service and datalink communications, while IAA provides the high frequency communication. The bulk of the North Atlantic traffic, about 80%, passes through Shanwick and Gander and there is substantial strategic and tactical co-operation with Nav Canada.
    b. Finally, the CAA considered Oceanic a relatively small part of the NERL business, representing c.4% of revenue or 3% of the RAB, and therefore the approach since the start of the Public Private Partnership has been to keep a simple RPI-X formula on charges. Given the small scale of the business, simplicity has been seen as a virtue.
    c. The CAA also provided an overview of the Oceanic process to date, from NERL's initial business plan in May 2013 to the Industry Seminar in September 2014.
    d. IATA asked about the traffic forecast underlying the CAA's proposals. Although the consultation document mentioned these were based on STATFOR's forecast, STATFOR doesn't provide a forecast specifically for Oceanic.
    e. The CAA explained that the traffic forecast used for Oceanic projections was provided by NATS and was based on the February 2014 STATFOR forecast and the annual STATFOR IFR Flight forecast for the North-West Europe to North America traffic flow 2014-2020. This was confirmed by NATS.
4. **Issues:**
    a. Turning to the substantive issues raised by the consultation document, the CAA explained that the first question it considered was whether it should continue to

regulate what is a small segment of the NERL business. Here it seemed that NERL has significant market power, given the exclusive ICAO mandate. Clear alternative constraints weren't apparent and the CAA pointed out that it is not clear how realistic the threat of UK losing the mandate is.

b. Another pertinent question the CAA considered was whether the costs of regulation might be higher than the benefits. In this context the CAA believed that the administrative burden of regulating the Oceanic service can be kept relatively low by retaining a simple cap with low process and information requirements.
c. The CAA noted that it is also mindful to avoid regulation getting in the way of innovation. This is particularly so for Oceanic where there is potential for satellite based systems to provide a step change in the service provided to the benefit of users. The CAA considered it can mitigate this risk by signalling up front that it would be prepared to re-open the price cap if a proposition was brought forward by NERL and was supported by users.
d. The CAA explained that the fundamental feature of the CAA's proposal was keeping to the simple RPI-X formula without the full requirements of the SES regime such as traffic risk sharing, service quality incentives and ex post corrections for inflation.
e. The CAA proposed to bring some of the features into line with SES to avoid unnecessary complications in the process. This included features such as moving from financial to calendar years, using CPI as a measure of inflations and correcting any under/over-recoveries in year n+2.
f. On the issue of inflation, the CAA explained that the current specification is based on charges being allowed to increase by the percentage increase in RPI minus a factor. This factor was referred to previously as 'Z' to distinguish it from the RPI-X specification for the remaining of NERL business. The CAA's current proposal is based on CPI as the index of inflation rather than RPI to give some consistency between Oceanic and the rest of NERL business, which is obliged to use CPI under SES.
g. The CAA considered that over time the increase in CPI tends to be somewhat lower than the increase in the RPI. The CAA's proposal under the new CPI cap will make full allowance for this difference between the expected movement in RPI and CPI. The CAA also considered that in the event the variance between the increase in RPI and CPI is different to what was expected, the variance should be small and relatively symmetrical.
h. IATA asked if the CAA eventually plans to move from the proposed approach of adjusting for the RPI-CPI variance and just move to a full CPI based approach.
i. The CAA explained that given the way financial markets work some elements of the price control, such as the cost of capital, will continue being based on RPI and so a full CPI based approach would not be possible[1]. However, the CAA considered this approach should be explored in the future. It would require NATS to rebuild its financial model which would also take time.
j. The CAA asked stakeholders to note the contextual questions presented at the end of the 'Issues' chapter in the consultation document. The CAA asked for stakeholders to consider these in their written responses.

[1]Additional note: In the RP2 Plan, the CAA used CPI as specified by SES legislation for the assessment of costs, but will continue to use RPI for the basis of indexing the RAB. This means investors are compensated for inflation through RPI indexation, and therefore the real return requirement should be expressed in relation to RPI.

5. Before moving on to 2015-2019 Projections, the CAA referred to a slide on Oceanic performance in 2011-2014. The CAA explained that the figures included in the consultation document [Figure 2.3 and Appendix B] were based on the regulatory accounts in each relevant year. NERL has since pointed out to the CAA that some figures were subject to subsequent post year corrections. The CAA therefore presented an update of these figures, highlighting the differences.
6. **Projections:**
    a. The CAA explained that the starting point of its projections was NERL's Revised Business Plan (RBP), produced following customer consultation. The CAA then applied interventions equivalent to those made for the RP2 Performance Plan under SES. Applying these to the NERL financial model produced a proposal of a 2015 charge with a real reduction of 1.25% on 2014, followed by CPI-5% p.a. in each of the following four years.
    b. The CAA presented the individual interventions made to staff opex: increase limited to CPI, intervention on pass through of under/over of pension costs recovery, allowing only part of the employee share scheme relating to new distributions of shares and removing opex contingency. The effect of these interventions led to a difference of some £0.8m per year between the NERL RBP and the CAA's proposal.
    c. The CAA adopted NERL RBP capex projections unaltered as they enjoyed reasonable support from users, the CAA consultants found nothing amiss with the capex plan generally and because there may be significant disbenefit to users if the CAA were to make an intervention which had the effect of delaying a programme. The CAA's proposal was therefore based on a programme of investment of some £3.8m in 2012 prices over the 5 years. As a result there was effectively no difference between the CAA's proposal and the NERL RBP projections for regulatory depreciation.
    d. On cost of capital, the CAA proposed the same WACC as used for NERL under SES. While there is different traffic risk, the CAA considered it was appropriate to assume the same CoC as: financing of NERL was conducted on a company-wide basis, expert consultants advice was conducted at NERL level, any Oceanic-specific cost of capital would have to take account of the different effective tax rates, the CAA did not attempt to analyse other components of the NERL business separately (such as the MoD contract), and the general de minimis arguments of the small scale of the Oceanic business and small effect on charges in absolute terms from adopting a different cost of capital. Making the change in assumption from NERL RBP's 7% to the CAA's proposed 5.86% implies a reduction in the regulatory return of about £1.1 million over the period.
    a. The CAA explained that the change from a March year end to a December year end will bring forward changes by 3 months which will have an influence on the projections and hence charges. The effect of bringing forward the use of lower traffic forecasts (which tends to increase charges) is just about counterbalanced by the effects of bringing forward the lower cost base for the coming reference period. The CAA noted that NERL previously pointed out that this estimate of the effect on costs did not include the removal of contingency cost.
    b. Furthermore, the fact that the Oceanic charge for 2014/15 will only be in place for 9 months will result in a benefit of +£0.8m for NERL as it will contain relatively more peak traffic and less off-peak months. However, the CAA pointed out that this

unanticipated benefit to NERL (which NERL pointed out to the CAA itself) is not as great as the revenue shortfall due to lower traffic in that year compared to what was anticipated. On balance, the CAA did not propose to make any adjustments to the recovery in 2015-2019 based on these transition effects.

c. Virgin asked for clarification where the revenue shortfall is expected from.
d. NATS and CAA explained that traffic fell short of the CP3 projections in the last 3 years resulting in a lower rate of return in the last 2 years. NATS elaborated that most recent forecasts for the current year of CP3 also show a shortfall in actual traffic v. CP3 projections.
e. Finally, the CAA considered that it should continue to smooth Oceanic charges so that the percentage rate of reduction after the first year would be equal in each year; subject to NERL receiving the present value of its costs over the course of RP2 in total over the period. The proposed profiling was with a charge per movement of £64.93 in 2015 in nominal terms followed thereafter by a profile of CPI-5% in each year 2016 to 2019. The CAA noted that this is expected to have the same value of charges in present value as the undiscounted profile.
f. To sum up, the CAA presented an outline of the effects of various cost interventions on NERL RBP. The CAA explained that in total the interventions would take a further £3.3 million (or about 2.7%) out of the NERL RBP cost base over the five years.
g. The CAA asked stakeholders to note the questions presented at the end of the '2015-2019 Projections' chapter in the consultation document. The CAA asked for stakeholders to consider these in their written responses.
h. NATS also clarified that the CAA's reference to 'Eurocontrol' part of NERL business in the presentation meant NERL UK en route business. The CAA confirmed this.

7. NATS Trade Unions (TUs) considered that applying the interventions made under SES to Oceanic was cherry picking adjustments that may not be appropriate for that part of the NERL business. TUs were also concerned that this approach would suggest a move towards including Oceanic in the SES scheme. This position will be elaborated on in TUs' written submission.
8. The CAA explained that the interventions made under SES were not driving the proposals for Oceanic, but rather that the CAA considered these to be reasonable and appropriate interventions to begin with. The CAA noted it did not intend to include Oceanic in the SES scheme.
9. The CAA concluded the meeting with an overview of the process going forward. The CAA informed stakeholders that it expects to issue a formal notice to modify the NERL licence in mid-October, alongside modifications resulting from SES. The CAA then expects to issue a decision in early/mid-December so that the control can take effect from 1 January 2015. The CAA noted that this timeline is on the basis that NERL does not exercise its right to appeal to the Competition and Markets Authority.
10. CAA reminded that the **deadline for written responses is Thursday, 25 September 2014**. The CAA also pointed out that the timescales after this date will be tight and therefore the CAA asked the stakeholders to meet this closing date.