

Martin Rolfe
Chief Executive
NATS
Corporate & Technical Centre
4000 Parkway
Whiteley
Fareham
PO15 7FL

Sent by email

25 September 2018

Dear Martin

NERL's RP3 business plan

In our business plan guidance (CAP 1625, published January 2018)¹, we set out our expectations for NERL's business plan for Reference Period 3 (RP3) and in May 2018, we wrote to you setting out our early and high-level views on the RP3 initial business plan (IBP).² In the intervening period we raised a number of detailed issues and we sought further clarity and evidence to support our understanding and assessment of your IBP.

I note the Customer Consultation process came to a close last week and welcome the positive feedback from both airspace users and my team on how NERL has prepared for and engaged in the process, seeking to clearly explain its proposals and responding to issues raised by airspace users. Having reviewed the further information that has been provided and the initial output of the Customer Consultation Working Group (CCWG), we are now able to clarify our expectations with respect to the revised business plan (RBP). This largely builds on points we have raised in various working level discussions between CAA and NERL, which you may already have in hand, and clarifies some important points about the wider context.

We recognise that recent increases in air traffic, and future demands on NERL resources in support of airspace and technology modernisation, may raise challenges for you as an organisation. However, it is important through the business plan submission and review process that we rigorously consider how NERL plans to meet those challenges efficiently.

Our original business plan guidance explained the importance of the NERL taking ownership and accountability for airspace modernisation (as part of our strategic

¹ CAA, "Guidance for NERL in preparing its business plan for Reference Period 3", CAP 1625, January 2018

² CAA letter from Richard Moriarty to Martin Rolfe, "NERL's RP3 initial business plan", 25 May 2018

outcome of effective accountability) and in particular “*how it will develop a coordinated and sequenced masterplan of UK airspace changes between 2020 and 2040.*”³ We understand through the CCWG process that certain stakeholders have expressed the view that an independent entity might be better placed to impartially coordinate the introduction of a masterplan. We, and the Government, will consider these issues further, but for the purposes of your RBP you should continue to assume that this role falls to NERL. Appendix A provides an update on policy developments since publication of our guidance and our expectations on what we expect a masterplan or design roadmap to consider.

Your IBP says that noise should be addressed through the Airspace Change Process. We consider this does not fully address the expectations in our business plan guidance.⁴ In the RBP we expect NERL to explain the levers it has to mitigate noise (and any trade-offs with other externalities) and the limitations of its levers. You should expect to abide by existing and emerging DfT policy and CAA requirements on noise, including from airspace design, redistribution of air traffic and new requirements from the DfT’s Aviation Strategy. You should also expect to take account of noise in designing your operational activities (within the framework of safety, policy and process requirements) and to have to work with wider stakeholders as part of the UK airspace design and implementation masterplan, described above, to identify opportunities to mitigate noise impacts.

In due course we expect to bring forward modifications to NERL’s licence that will set out NERL’s obligations with respect to airspace modernisation and noise.

Building on this wider context your RBP should also deal with the following issues.

Cost efficiency and operational resilience – The IBP provided limited evidence that NERL had considered the trade-offs between cost-efficiency and resilience and had selected an option with sufficiently stretching targets for costs and service quality. NERL elaborated on these points during the customer consultation. Our advisers Steer and Helios have reviewed the IBP and will be updating their advice in light of the RBP. It is essential that in the RBP NERL elaborates further, to provide a clearer justification for these targets that shows how they have assessed the trade-offs against other options, and delivers the resilience customers want, in an efficient manner. The RBP should also show the impact on NERL’s service quality, resilience and delivery plans if it was required to deliver Determined Unit Cost reductions in line with the range of values consulted on by the European Commission’s Performance Review Body, over the summer.

Investment plans – We identified in our May 2018 letter that there is a lack of optioneering and cost benefit analyses to support the proposed investment plan in the IBP. While additional information was provided through the customer consultation process, for the RBP it is essential that NERL provides stronger evidence on the customer and service benefits, and cost efficiency of its proposed RP3 investment plan. To date our advisers have struggled to develop a persuasive assessment of potential efficiency gains given the limited information provided. We have particular concerns with respect to the Lower DSESAR sub programme and airspace programmes. Where we are unable to confidently assess the value for money of the capital programme we will have difficulty in making a full allowance for the capital expenditure proposed. This should be supported by robust and meaningful shared governance arrangements. As we move into RP3 implementation, we expect NERL to demonstrate a more transparent approach to optioneering as part of future Service and Investment Plan decisions.

³ CAA Guidance page 30

⁴ CAA Guidance page 28

Consumer views – Our guidance sets out that your business plan will need to address wider interests including those of current and future consumers and non-customer interests such as overflowed communities, not just airlines.⁵ The CAA’s Consumer Panel has raised a number of issues in relation to the IBP, in particular in relation to how NERL has sought to understand and take account of consumers’ interests and how NERL’s operations might impact consumers – especially where consumers’ interests and airlines’ interests may diverge. The CAA Consumer Panel’s note is reproduced in Appendix B – as far as reasonably practical you should take account of the Panel’s recommendations in the RBP.

Pensions – Our guidance sets out that NERL’s business plan should “*explain and, where appropriate, provide evidence for how it can help manage the risks associated with a [Defined Benefit] DB scheme in a way that acknowledges and respects that it is underwritten by customers, i.e. in the interest of customers.*”⁶ Since the IBP, NERL has provided additional evidence on the 2017 pensions valuation and benchmarking to support our review of pension costs, which will also be informed by advice from the Government Actuary Department. However, as set out in the guidance, we expect NERL to set out its approach to managing the risk of trapped surpluses and any associated high-cost de-risking in a way that is in the interest of customers.

Oceanic – We welcome the energy and detail with which your team has engaged on the use of satellite ADS-B surveillance over the North Atlantic. For the RBP, it is essential that NERL builds on progress made, through this positive approach, to address airlines’ concerns. NERL should provide better evidencing of the assumptions made in its benefits case (including of downside risks to the assumptions made), and of the efficiency of the proposed data charges for the service. NERL should provide a clearer justification for the proposal to treat data charges as a pass-through cost to users that explains why this represents appropriate allocation of risk.

London Approach – Our guidance set out that we expect NERL to “*review the scope of the London Approach service and establish metrics, forecasts and conduct sensitivity analyses consistent with the requirements for En Route, appropriately modified to align with the nature of the London Approach service to enable effective monitoring of performance.*”⁷ Following the publication of the IBP, your team has engaged positively to consider scope of the London Approach service. For the RBP, it is important NERL provides sufficient information to enable assessment of the impact of changing the scope of the regulated London Approach service both in terms of those airports already within scope and those that are not. We expect this to explain how your plan would be affected if the scope was unchanged, and if London Biggin Hill Airport was added to the scope. We expect NERL to build on the material it has published as part of the customer consultation process and, in due course, propose measures for reporting its performance on London Approach.

NERL commercial interfaces – In our letter of May 2018, we said NERL needs to provide additional clarity and transparency about how it manages interfaces between NERL and NATS’ non-regulated activities. In the RBP it is important that NERL sets out how it satisfies itself and its customers about the value for money it achieves when it delegates functions to or buys services from NSL and when NSL buys services from NERL. It is also important to explain how NERL delegates or sells services in a way that

⁵ CAA Guidance page 53

⁶ CAA Guidance page 44

⁷ CAA Guidance page 23

ensures it acts impartially and provides equality and transparency of opportunity between NSL and potential and actual competitors for those services now and in the future.

Electronic conspicuity and drones – While we welcome the ideas put forward and acknowledge the issues raised in your IBP, it is important to recognise that no decisions have been made by the CAA or Government on NERL’s future role in drone traffic management. For the RBP, NERL should set out the landscape and the challenges of safely integrating drones and new types of vehicles into UK airspace to co-exist with other airspace users in a way that in the future maximises access and benefits to all. Where investment funded by user charges is proposed, it is important that NERL provides a clearer justification for its investment, what is being delivered and why it is required to deliver continued levels of safety in controlled airspace. NERL should also set out how it will ensure that it does not provide a commercial advantage for NSL in the drones market as a result of NERL’s investment. Beyond the RBP, we would welcome further information on NATS vision, and strategy for drone integration in the context of the wider airspace management plans.

Cost of capital – Our guidance sets out that NERL should assume a cost of capital “*no more than the efficient level necessary to compensate NERL for the business and regulatory risks it faces.*”⁸ The IBP proposed a post-tax (‘vanilla’) WACC that was higher than at RP2. In discussions with NERL, we raised concerns that the cost of equity in the IBP is higher than the early and preliminary views on the cost of capital for the next Heathrow Airport price control review in CAP 1610 and recent papers from UK regulators. It would be helpful for NERL to consider these points and the evidence and reasons, when developing its RBP.

Financeability – In the IBP, NERL provided modelling to demonstrate that the plan is financeable. Consistent with our guidance,⁹ there would be benefits from NERL also demonstrating:

- why the target credit rating is appropriate;
- what corresponds to a successful financeability test;
- what appropriate actions could be used to resolve any financeability issues that are also consistent with affordability; and
- that the RBP is financeable on the basis of NERL’s core activities and separately on the basis of core and wider activities.

Assurance – Our business plan guidance sets out that NERL should demonstrate that its financial model should “*meet best practice standards for a model used for regulatory price control purposes, including appropriate levels of assurance around its logical integrity and usability.*”¹⁰ It is essential that NERL submits a complete suite of financial models with the RBP that reconcile to the assumptions and price control proposals in the RBP and appropriate levels of assurance. We are aware that NERL is taking positive steps around model assurance for the RBP. To provide the necessary assurance to its customers and the CAA, we expect this to meet best practice standards, including being transparent to your customers and clear on the level of assurance provided and any limitations. We would expect NERL to undertake appropriate targeted assurance to cover any limitations and other technical areas (e.g. opening RAB, tax allowance) that are material to the regulatory price control.

⁸ CAA Guidance page 46

⁹ CAA Guidance page 50

¹⁰ CAA Guidance page 69

We recognise and welcome the significant efforts of your team in providing further information for our working level discussions between June and September, alongside your comprehensive and constructive customer engagement programme. We hope that the points raised in this letter provide useful clarity on our expectations for your RBP and, if helpful, we would be available to discuss any of these points.

As discussed, we will publish this letter on the CAA's website.

Yours sincerely

A handwritten signature in black ink that reads "Paul Smith". The signature is written in a cursive, slightly informal style.

Paul Smith
Director, Consumers and Markets Group

Appendix A – UK airspace design and implementation masterplan to 2040 and airspace modernisation requirements

1. Since publication of our business plan guidance to NERL in January 2018, there has been significant development of the strategy and policy in respect of UK airspace modernisation, culminating in the publication of a draft Airspace Modernisation Strategy (CAP 1690, published in July 2018).¹¹ In this appendix we set out more precisely our expectations about NERL's role in the UK-wide airspace design and implementation masterplan for airspace design changes up to 2040 that we expect to see reflected in the RBP and NERL's licence in RP3.
2. The Government published in 2017 a Strategic Rationale for Upgrading UK airspace, setting out the rationale for a wholesale redesign of the UK's airspace to meet future demands on this finite piece of infrastructure. Delivering this outcome will be one of the key components of the UK's 2040 Airspace Modernisation Strategy currently being prepared by the CAA.
3. Given NERL's strategic role as the UK's monopoly provider en route and other air traffic management services to a range of airspace users, we think it is best placed to be responsible for drawing together a UK-wide airspace design and implementation masterplan between the start of RP3 and 2040. NERL would be accountable for producing the plan in accordance with Terms of Reference that the CAA and DfT would set. This will include the need for NERL to develop the plan by engaging effectively with relevant organisations, such as the airports using the airspace in question. In addition to developing this system wide plan, we expect NERL to be responsible for sponsoring a number of individual airspace design changes set out in that masterplan.
4. This UK airspace design and implementation masterplan is required for three reasons:
 - i. To enable CAA to understand how individual changes relate to each other and therefore take better informed decisions
 - ii. To inform the use of potential new legislative powers to compel airspace change to happen. Our assumption is that being included in the masterplan would be one of the triggers for the use of these powers
 - iii. To identify opportunities to improve airspace design that will deliver a wider set of benefits, not just to increase capacity.
5. The CAA recognises that NERL does not itself possess at present all the operational knowledge to write this plan itself but building on the collaborative approach it has taken to the Feasibility Assessment and the LTMA and FASI-S Working Group, we would expect NERL to work collaboratively with a wide range of stakeholders across UK aviation to deliver this plan in a number of phases. The first phase should tackle the work of airspace design change in the South East of the UK including those changes required to facilitate new runway capacity, the second phase those required as part of the FASI-North group and finally those required in other parts of the UK. The plan should identify *where* new changes are needed and *why*, but would not include any design work (which must be owned by the airspace change sponsor in accordance with CAP 1616). Our current expectation is that a full draft of the masterplan should be available by the end of 2020 and for it to address each of the following requirements between now and 2040:

¹¹ CAA, "Draft Airspace Modernisation Strategy", CAP 1690, July 2018

- a) Identifies, against evaluated alternatives, where airspace changes are needed to deliver capacity, for example:
- airspace bottlenecks where delays to consumers could be alleviated by capacity
 - areas where planned development on the ground such as new runways will require new airspace designs
 - areas where more direct routes are possible that could, for example, reduce controlled airspace
- b) Identifies, against evaluated alternatives, other changes that may be required deliver one or more of the following benefits:
- where airspace changes are needed to deliver a safety benefit, for example, changes that keep routes far enough apart from one another
 - where airspace changes can deliver noise benefits that are not in conflict with growth and do not have disproportionate dis-benefits for efficiency or carbon
 - where airspace changes can deliver air quality or fuel efficiency benefits
 - where airspace changes are needed to allow improved access to airspace for users, for example where the existence of controlled airspace is no longer justified
 - where airspace changes are needed to enable the military to fulfil their national security functions
 - where airspace changes are needed to introduce new technology, for example the introduction of performance-based navigation
- c) Identifies:
- the operational concepts required to deliver these changes and their level of maturity
 - the set of assumptions on which the proposed changes are based and are dependent
 - the key risks associated with delivering the plan and how they could be mitigated
 - the recommended coherent sequence of individual or modules of changes against the evaluated alternatives
 - the preferred timescale for their adherence against each step of the CAA's CAP1616 process and subsequent implementation
 - the party responsible for taking each individual airspace change forward
 - the inter-dependencies between individual changes
 - the minimum number of changes to ensure major airspace projects (eg to accommodate new runway capacity) are viable
 - the degree of commitment offered by each individual party.
6. As part of setting out its plans to undertake this task, we would expect NERL to also describe the arrangements that will give all stakeholders confidence of equal access to the process, and how NSL's commercial relationship with some of the stakeholders involved would not confer any additional status or influence to any particular stakeholder in the process.
7. We recognise that some of the work to create this plan is already underway, for example through the NERL Feasibility Assessment, the LTMA Working Group and work by individual airports on potential airspace changes.
8. We will continue to work with NERL to refine the request and Terms of Reference for this work. We have already received feedback on an initial draft of the text above and will address their comments in due course.

How should the consumerⁱ interest be reflected in NATS' final business plan?

Consumer Panel advice to CAA

About the CAA Consumer Panel

The CAA Consumer Panel is a non-statutory body established to act as a 'critical friend' to the CAA. It provides expert advice to make sure that the consumer interest remains central to CAA policy development.

Background: The CAA Consumer Panel and NATS regulation

In 2015, the Panel supported the case the CAA was making to DfT for NATS regulation to bring it more into line with other regulated industries. We complimented the CAA on its work and said that a compelling case for reform had been made. Unfortunately, the proposed reforms were lost in the process of the 2017 general election.

We have now been asked to input to the development of the CAA's performance plan for NATS for the RP3 period (2020-24). We have seen NATS' draft business plan, and a group of Panel members were briefed by Matt Claydon on 15 August. The main questions posed for the Panel are:

- Where is there a genuine consumer interest in ATS?
- Where do airline interests diverge from this?
- Where can the CAA take action? Is the approach to the consultation broadly right?

Safety is the paramount consideration in NATS' regulatory regime, and the current rules do not allow for safety to be "traded" against other types of user benefit (capacity, cost or efficient operation). As a result, in order to be compliant with safety regulations, NATS may reduce capacity instead of finding ways to ensure compliance, with implications for delays and service quality facing consumers.

The Panel's views

1. Where is there a genuine consumer interest in ATS?

NATS is delivering a critical service for consumers. While consumers are not sighted on the way in which NATS services affect them, they are impacted by its efficiency of operation, investment programme and capacity. In turn, these directly affect airlines' service disruption and continuity, and indirectly affect airfares. Depending on competitive conditions in the airline market, they may also be affected by NATS costs and charges to airlines.

NATS charges form an appreciable part of airlines costs (6-12% of airlines' cost base, depending on carrier). We note that NATS efficiency has significant effects on airlines' fuel costsⁱⁱ. We would expect consumers to have an interest in ATS charges and their effects on airline costs in just the same way as they do in any other components of their ticket price.

There was little in NATS' draft Business Plan that recognised the impact on consumers, or their understanding of those impactsⁱⁱⁱ.

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2. *Where do airline interests diverge from this?*^{iv}

We take the view that consumers (air passengers and air cargo customers) have interests that are not always completely aligned with those of NATS direct customers (airlines).

While there is a good alignment of economic interests in normal circumstances and for “average” passengers, there can be a systematic divergence. For example:

- *During disruption* – profit-maximising airlines make rational choices that will tend to favour certain groups of consumers^v. Groups who may be disproportionately affected by the choices airlines make include budget travellers and PRMs.
- *Market power* – to the extent that any airlines have market power at any airport they will have an incentive to restrict supply. This may manifest itself in lower levels of investment in capacity and traffic management than consumers would demand.

It is not nearly adequate to limit consultation to the airline community and to assume it is a proxy for the consumer interest: the “rebuttable presumption”.

3. *Where can the CAA take action?*

The Panel supports what the CAA is doing to make NATS more accountable for delivery to its direct customers

However, we consider that not enough has yet been done to understand and incorporate the needs of consumers. We recommend that the CAA should:

- explicitly reference the requirement in TA00 to “further the interests of ... persons travelling in aircraft and persons with rights in property carried in them” and formally rebut the presumption that the interests of airlines are fully aligned with the interests of consumers
- consider and seek to apply the principles of ex-ante regulation focused on outcomes for consumers, in line with its intentions in 2015, even if it does not currently have the legal authority to enforce them - we want to see sharp consumer-focused outcomes with underlying measures, targets and incentives that support these outcomes
- take the opportunity to update the guidance to NATS set out in CAP 1625 by requiring NATS to show that it understands and that it is considering and properly reflecting the interests of consumers where they diverge from those of airlines. In this respect, surveys of consumers are unlikely to be very helpful as the issues are likely to be hidden. Focus groups and “citizens jury” approaches may be more helpful, as would drawing on conclusions on airline/consumer divergence from the H7 CCB and commissioning a competition economics assessment of areas where airline and passenger interests diverge, and what regulatory tools can be used to address them.
- require NATS to gather and reflect evidence on what “the travelling public expects” in the next iteration of the business plan^{vi}.
- approach this price control as it does H7, where the Challenge Board has been established to ensure the consumer voice is heard and that consumer engagement by HAL is at the heart of the business plan. The process doesn’t rule out the importance of the airline perspective, but it recognises that the perspectives and interests are different.^{vii}

As suggested at the meeting it is already quite late in the RP3 process to do all of the above effectively, and it may be more realistic to aim at RP4 (the process would start in late 2021 if its timetable was similar to that of RP3). Nevertheless, in the interests of consumers (i.e. the CAA's primary duty), we urge the CAA to consider what it can do now, to work with NATS in order to articulate better the recognition that consumers have a valid and essential interest

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its work. Embedding the consumer interest should not just be about ticking the box to meet regulatory requirements at the time of the price control but about changing the culture of the business on an ongoing basis

Robert Laslett

Trisha McAuley

David Thomas – prior to joining the Panel

CAA Consumer Panel August 2018

ⁱ All references to consumer mean final consumer as opposed to airlines, which are “customers” of NATS

ⁱⁱ “we estimate savings, after the cost of satellite data, of between \$153 and \$312 for a full North Atlantic flight” Draft Business plan P52.

ⁱⁱⁱ By simple word count, “customer” was mentioned 172 times compared to 17 times for any of “consumer”, “travelling public” or “passenger”

^{iv} There are two potential divergences of interest: between NATS as a monopolist and the airlines as its direct consumers; and between airlines and consumers. The CAA feels that NATS is oddly unresponsive to airline interests, and the presentation to the Panel on 15 August noted “a general reluctance by NATS to take accountability (for delivery) over the years”. This might be a result of NATS history as a part of the regulator up to 2001, or of the unresponsiveness of a monopoly provider to customer interests. Governance arrangements seem not to have aligned customer and shareholder interests. The government has a 49% stake and golden share in NERL and seems to take a taxpayer perspective. Airlines and airports also have a sizeable stake (about 25%) but seem also to take a conventional shareholder financial perspective. Pension funds (the USS and PPF) and NERL employees hold the remainder and are not aligned with consumers. We support the CAA in trying to make NATS more responsive to its customers’ interests.

^v This pattern is seen in the order in which flights are laid off by airport committees at times of airport disruption.

^{vi} For example, the Aviation Index, <https://www.nats.aero/static/aviation-index/> a quantitative survey carried by Ipsos Mori, seems to have been published after the initial business plan. It has some interesting findings e.g. 46% are not keen on the new digital towers. It is basic, but it at least articulates the passenger perspective and should stimulate a focus on outcomes for the end consumers whose actions should drive industry performance and service quality. We do not, however, regard it as sufficient evidence of consumer engagement.

^{vii} This sort of process is also reflected in other regulated sectors, including electricity transmission which has some features in common with ATS.