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Luton, December 13, 2022

easyJet response to the Civil Aviation Authority 's Initial Proposals (CAP 2394)

Dear Sir/Madam,

We are writing to set out easyJet's position on the Initial Proposals (IPs) for the next price control review (NR23) produced by the Civil Aviation Authority (CAA).

We welcome the opportunity to submit written comments on the development of NATS Enroute Limited's (NERL) NR23 Business Plan, following the detailed and comprehensive IPs that the CAA has developed and shared with stakeholders.

We believe that the CAA's assessment of NERL's NR23 Business Plan is a step in the right direction and an improvement from the original Business Plan proposed by NERL. However, double-digit increases in prices for an essential facility is neither proportional nor justified by a proportional increase in service performance. Further improvements are needed to ensure the right balance between affordability of charges and financeability of the ANSP.

We outline below our specific comments to the CAA's IPs.

1. Traffic assumptions

We welcome CAA's decision to support the use of STATFOR forecasts, as this is an independent and reliable source of forecasting.

We understand that the CAA's Initial Proposals are based on the STATFOR October 2021 base-case traffic forecast (the latest available medium-term forecast available at the time of producing the Initial Proposals). STATFOR issued an updated medium-term forecast in October 2022 and we support the CAA adopting this latest available traffic medium-term forecasts for NERL's business plan in NR23. NERL operational resourcing plans should be adapted accordingly. Nevertheless, NERL still needs to ensure appropriate levels of service in the event of higher traffic than the one proposed.

We believe that the adopted forecast should be set at the midpoint between the high and base case forecast published by STATFOR in October 2022. Historically, the UK has been outperforming EU traffic growth rates, including for Summer 2022. We are also seeing healthy demand for our schedule in 2023[1] and we are confident next year's traffic will reach the proximity of its levels of 2019 in the UK.

2. Treatment of NERL's 2020-22 TRS Debtor

We reiterate our position that airspace users should not be responsible for financing NERL's losses during 2020-22. The traffic risk sharing (TRS) mechanism should not be applied in these circumstances as the drop in traffic was not caused by commercial decisions of airlines, but by the States' policy responses to a global pandemic.

In particular:

- NERL should not seek to recover the entire shortfall in revenue from 2020-22. The application of the TRS mechanism should at least be partial, meaning that NERL also absorbs at least 50% of its own losses;
- Any use of shareholder's funding, as referred to in paragraph 1.15 of CAP 2245 and in 6.21 of CAP 2394, should not result in airlines absorbing the COVID-related losses of NERL;
- State-funding should be the primary source for sustaining the revenue shortfalls, with NERL actively engaging with the UK Government together with the rest of the industry[2]. We invite NERL to follow the example of other ANSPs in Europe (such as Skyguide and ENAIRE) and collaborate with users so that charges remain truly affordable.
- The TRS debtor amounts should not be included in the RAB through the working capital, and we will explain our reasons more in depth in paragraph 2.3. NERL should follow other ANSPs (such as DSNA or DFS) and waive the regulatory return related to the TRS debtor.

We have set out our comments below on the CAA's IPs:

2.1 Proposed Recovery of the TRS Debtor in NR23 and NR28

We support the proposed 10 year recovery of the TRS Debtor equally distributed in NR23 and NR28 as a balanced approach. However, the CAA should also consider pushing some of this debtor even beyond NR28. Such increases in prices are in fact still painful for airlines in this environment.

2.2 Profiling of NERL's charges

We support the flat price profiling suggested by the CAA during NR23, as it allows for more regulatory and planning capacity from airlines.

2.3 Capitalisation of the TRS revenues

We strongly reject the concept of NERL producing any additional earning from the revenue losses of 2020-22 through the WACC with the amounts recovered adjusted for inflation, mirroring the treatment of the capex in the RAB. The TRS Debtor is in fact a "loss" that should

[1] As indicated in our FY22 Financial Results Presentation, based on a survey of 2,000 adults in the UK in November 2022, three quarters of people say travel is the top priority over the next 12 months and 64% of people plan to travel abroad in 2023.
Our summer 2023 season went on sale beginning of October and we were filling the equivalent of more than four A320 aircraft a minute in the opening hours demonstrating the continued demand.

[2] Although this is not in CAA's role to decide if Government support should be provided, we acknowledge CAA's neutral position on the issue, as stated in paragraph 1.16 of CAP 2119 and paragraph 6.21 of CAP 2394.

be funded through other means other than airlines' funding – through an unfair application of the TRS mechanism. Being a "loss", this should not turn into an additional inflation-adjusted profit for NERL. Revenue losses should not be treated as an investment or an asset (earning a return each year on the not yet depreciated part of the amount that remains in the RAB). The RAB should only indicate the value of net invested capital for regulatory purposes. The revenue losses, if funded though government grants or debt, would then represent a liability, instead of an asset.

If an essential facility is allowed to profit from losses deriving from a global pandemic, even adjusted for inflation, we struggle to understand what business risk the WACC of NERL tries to capture.

2.4 Adjustment for inflation

The additional real capital loss that NERL would incur due to inflation is also part of that same business risk. Even if we do not support the TRS Debtor to be included in the RAB, nevertheless NERL's RAB is indexed to inflation – which is also important to estimate NERL's WACC. We suggest using a notional level of inflation at 2% for NR23. This is the monetary policy target of the Bank of England (BoE). Given the high uncertainty regarding the inflation cycle during NR23 the use of a notional level is the most appropriate to minimise the risk that NERL is not under or over remunerated as eventually inflation will return to 2%, as per statutory duty of the BoE. It would also avoid the CAA having to update its inflation forecasts, offering more regulatory certainty to stakeholders.

3. Reconciliation review

We strongly support the analysis made by the CAA and the consultants of the reconciliation of the efficient cost baseline, where the TRS debtor is £58 million lower than NERL's determination. However, we have some specific comments below.

We understand that the regulatory return for UKATS over the reconciliation review period is forecast to be 21% higher than the forecasts set out in the CMA determination, from the capitalisation of the TRS revenues. As previously stated in paragraph 2.3, we do not agree with the choice of allowing NERL to earn a return on the capitalisation of the TRS revenues to be recovered in the RAB.

NERL undertook refinancing in 2021; and those costs were not reflected in NERL's regulatory return between 2020 and 2022. NERL should not be allowed to recover from users an allowance set by the CAA (£16M) on the bond interest costs incurred before its restructuring in June 2021 and the cost of redeeming its existing bond, as these represent an autonomous business decision undertook solely by NERL, not with the collaboration of the users. NERL will already recover the TRS revenues from airspace users, and part of these should be used to pay for the refinancing costs incurred.

4. NERL's costs

We understand that estimating NERL's costs requires dealing with a number of uncertainties for NR23, especially around the macroeconomic and traffic environment. We suggest that the CAA plans for NERL's efficient costs during NR23 considering:

- a traffic forecast above the base case of the STATFOR forecast of October 2022, and
- an inflation level at the notional value of 2%,

for the reasons explained in paragraph 1 and 2.4 above.

We set out our specific comments below:

4.1 Inflation and the 2022 cost base

We disagree with the approach taken by the CAA to fully adjust the 2022 nominal cost base by inflation, given the significant proportion of costs that do not necessarily move at the same rate of CPI's forecast (including staff costs and pension costs that represent more than 70% of NERL's OpEx). We expect, for 2023-27 as well, that NERL will be able to mitigate any increase in inflation so the full increase is not passed through in its cost base.

4.2 Staff Costs and Productivity

It is important that operational resourcing is sufficiently cautious to support the recovery of air traffic, but improvements on cost efficiency of staffing are needed over NR23. It has been shown in the IPs, as we suggested, that NERL's staff costs have increased faster than general inflation and wages across the UK economy in the past and are higher than other comparator's groups' market rates. We thus agree with the CAA's approach to assume a slower wage growth in NR23, below CPI. Following our comments on notional inflation of 2% to be used as an estimate for NR23, we suggest that the CAA adopts a level of efficient costs allowances closer to the low case.

NERL's plan did not assume any productivity gains for its operations. The increases in the number of ATCOs over NR23 should also factor in any productivity improvements over NR23 as a result of investments in systems and processes (such as airspace modernisation programs and improvements to training and rostering). We support the CAA's assumption that NERL should be able to achieve productivity growth of 1.5% year on year from 2025 onwards, as this represents a more realistic estimate, given historical data.

4.3 Pension Costs

We support CAA's estimations for the efficient cost allowances for UKATS pension costs in NR23. To reflect the appropriate level of efficiency in the staff cost, we think that the reduction in pension costs should follow the low range of the efficient range, given our suggestion to use a low inflation estimate.

4.4 Non-staff OpEx

We support CAA's revision of non-staff OpEx of NERL in NR23. In particular, we welcome the removal of the additional costs for dealing with new airspace users (such as drones) from the tariffs. Users should only pay for the services they receive.

5. CapEx

We believe that technological upgrades and airspace modernisation are key NR23 priorities. Nevertheless, we remain concerned about the impact on consumers of the costs increase reported in the final iSIP22 document and the continued delay to the DP En Route programme.

It remains challenging for the users to fully understand the costs associated to its CapEx program given the changes in the timescale and scope of the projects (such as the DP En Route Programme), and the associated service and cost benefits for the users. We wait for NERL's updated NR23 capex programme, which, once finalised and shared with users, we expect to be consulted upon. Our priority is for the capex programme not only to deliver evident efficiency and productivity gains for the users, but also a modern fit for purpose UK airspace and the industry's sustainability needs. We request the CAA to equally adopt the low case for the efficient cost allowances for UKATS capex, in accordance with the considerations made about the OpEx; and to reflect the lack of detail and information in NERL's capex plan. Moreover, we request further efforts from the CAA, subject to evidence from NERL, on the containment of the capex NERL has requested for its role in airspace modernisation and ACOG operating costs.

We finally invite the CAA to investigate the appropriateness and the justification of the additional investment cost of £85m planned by NERL as a result of the post covid revised implementation plan.

6. Depreciation

For the avoidance of any doubt, in our comments on the proposed NERL business plan for NR23 dated 10 March 2022, in relation to NERLs' proposals on Regulatory Depreciation, we supported the depreciation deferral of £108m as initially suggested by NERL, as this would have helped to lower prices for users in critical recovery years.

7. Cost of Capital

We continue to have concerns with NERL's focus on ENAV and four European airports (AdP, AENA, Fraport and Zurich Airport) as the main comparators for its WACC estimation. Airports tend to have less revenue protection than ANSPs and a different risk profile related to their international investments outside of Europe. NERL provides a public interest service with the power to increase unit rates above prices that would exist in a competitive market. NERL also has the right under regulation to be compensated for *any* revenue losses by applying for an increase in unit rates as per TRS mechanism. For this reason, we believe that it is more appropriate for NERL to use a larger sample of peers to estimate the WACC. As mentioned in the report from Oxera from October 2021, Copenhagen and Wien Airports, and other non-aviation comparators, such as the National Grid ESO or SONI, should be included in the set of comparators for NERL's WACC.

Moreover, we do not agree on the Equity Risk Premium measure applied, derived from long run historical averages. The underlying assumption of this choice is that investors' risk sentiment – and thus the required premium – have remained stable over the historical period examined. We suggest using the estimates publicly provided by Professor Aswath Damodaran. He estimates a country's Equity Risk Premium by adding the country risk premium derived from Moody's currency sovereign rating on top of US' s equity premium. As of January 2022, the latest available estimate, the Equity Risk Premium for the UK corresponds to 4.84%[3].

8. Service Quality

We welcome the CAA agreeing with our requests to encourage better performance for NERL during NR23.

8.1 Environment

We welcome the CAA's environmental targets update taking into account in full the expected benefits of NERL's capex programme. However, we repeat again that these targets

[3] Datum available at https://pages.stern.nyu.edu/~adamodar/New_Home_Page/home.htm

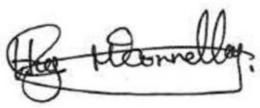
could be further improved. We think that a 10% reduction in CO2 emissions by 2035 is achievable.

We understand the CAA proposes to retain the 3Di metric for NR23. However, having already expressed some concerns about the measure not appropriately capturing flight planning and tactical flight operations priorities, we support NERL's commitment to work with its stakeholders during NR23 to improve the metric for NR28.

8.2 Capacity

We welcome the CAA's decision to raise the performance targets of NERL for NR23 to more ambitious levels, given better pre-pandemic performance in higher traffic. This also reflects the expected impact from the increase in traffic levels and benefits from the capex programme.

Sincerely,



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