Andrew Walker
Civil Aviation Authority
CAA House
45-59 Kingsway
London
WC2B 6TE

David Phelps
NATS
5th Floor, Brettenham
House South
Lancaster Place
London
WC2E 7EN

10 November 2017

By email only: andrew.walker@caa.co.uk

Dear Andrew,

Subject NERL response to CAA consultation on "Guidance for NERL in preparing its business plan for Reference Period 3" (CAP 1593)

This letter sets out NERL's comments on the CAA's document "Guidance for NERL in preparing its business plan for Reference Period 3" (CAP 1593).

We welcome the opportunity to own and justify key assumptions in our business plan. However, in a number of cases we believe there is a need for regulatory guidance or assurance on assumptions including those:

- where the Regulator has a leading role (eg charging mechanisms);
- which are so material to our plan that timely regulatory assurance is needed to avoid significant late re-work or changes, which would undermine the fidelity of the customer consultation process (eg pension pass through).

These are highlighted in our response, and are summarised at the end.

Our initial Business Plan will aim to balance day-to-day service delivery expected by our customers with the transformation of the UK's ATM system for the years to come. This is critical to meet the future demands of our customers, and the travelling public, as by 2030, forecasts suggest the UK will have c3 million flights carrying c355 million passengers[1] each year.

In RP3 major airspace modernisation is essential. This will be underpinned by our programme to move to a new suite of resilient and secure technical systems, which will transform the way we provide air traffic services. Therefore, our initial Business Plan will set out how we will deliver the service requirements in RP3 (in terms of safety, service quality and resilience) together with actions required to support future regulatory periods.

We respond to each of your questions in turn below.

[1] p11 "UK Aviation forecast", DfT, October 2017

1. Do stakeholders consider that a two track approach to NERL's business plan is reasonable?

In CAP 1593 the CAA sets out a two track approach with:

- 'Core' requirements – baseline business plan incorporating known and expected requirements; and
- 'Wider' requirements– supplemental information setting out the incremental effects on costs and performance of less certain requirements and possible future developments.

We support the two track approach and our initial Business Plan will follow this structure but with some key refinements as follows:

'*Core' plan* – the baseline business plan will incorporate known and expected requirements and include alternative options where available to provide customer choice. Taken as a whole, the core plan will contain the resources required not only to deliver a day to day service which meets customer expectations and ensures licence compliance, but also to enable us to make essential developments to prepare for future reference periods.

'Wider' plan – the wider plan will include supplemental information setting out the incremental effects on costs and performance in ranges for less certain requirements and possible future developments where quantifiable. If these are not quantifiable then we will make a directional statement.

Depending on the degree of uncertainty and quantification possible, such costs could then be accounted for either through:

- A FAS Facilitation Fund-type allowance for opex and capex (ie built into price but with a true-up in RP4 if unutilised). Examples might include airspace changes for hotspots; or
- A pre-defined trigger mechanism (where costs are not built into initial Business Plan prices but with a means of doing so in RP3 if certain pre-defined criteria are fulfilled and subject to appropriate governance). Examples might include drones and Brexit where the impact on NERL is currently unknown.

2. Do stakeholders have views on the allocation of activities and outputs between the core and wider categories for NERL's business plan?

In answering this question, we comment on each of the key areas listed in Chapter 2 of CAP 1593.

Safety

The CAA recognises that safety should be a pervasive feature of NERL's business plan and its central focus. However, we note that safety is not listed in the key areas described in Chapter 2 ("Outcomes and outputs for RP3") of CAP 1593.

Consistent with our response to CAP 1511, in which we expressed our strongly held view that safety should be the leading strategic outcome, we believe it is important to agree what level of safety is "safe enough" in RP3. Currently, the UK "Acceptable Level of Safety Performance" (ALoSP) comprises three safety performance measures, defined in the UK State Safety Plan as:

- "Fatal accident rate 5 year rolling average is in the best 5% of States";
- "SPIs track the frequency of operational events regarded as potential precursors to fatal accidents, and indicate continuous improvement in reducing these risks"; and
- "Compliance with ICAO Standards, Recommended Practices and Procedures (SARPs) of at least 90% with sound and considered rationale where differences have been filed".

Our view is that compliance with the UK State Safety Plan and the ALoSP measures will meet the "safe enough" requirement for RP3. Therefore, the core part of our initial Business Plan will contain resources to fulfil our obligations as defined in the UK State Safety Plan, and meet the EASA requirements, as we believe these set out the appropriate requirements.

We would also like to highlight the criticality of full electronic conspicuity across the London and Scottish FIRs – particularly as unmanned traffic grows. Therefore, we urge the CAA to require all classes of airspace users to be equipped to support full electronic conspicuity. Until such a requirement is in force, the related air traffic management systems upgrades will be considered as elements of the 'wider' plan.

Capacity

Our Licence requires us to "maintain the most expeditious flow of air traffic as a whole without unreasonably delaying or diverting individual aircraft". This means managing the UK air traffic management network as a whole, ensuring network efficiency.

Given this requirement, which remains appropriate, we see no benefit in establishing separate metrics, targets, forecasts for en route and London Approach. Segmenting different parts of the network in this way is not consistent with the Licence requirement described above. Such an approach could drive optimisation of one part of the network at the expense of other parts, producing a sub-optimal result for overall network efficiency, and potentially benefitting some customers while adversely affecting others. However, as part of the work of developing our proposed capacity targets we will have due regard to the performance required in all parts of the network, including London Approach. As a means of monitoring performance in London Approach, we will continue to report an equivalent 'C2' metric for London Approach via the Condition 11 reports.

In our view, like all metrics designed to drive the right outcomes, the capacity metrics should be fair and representative of what is fully within our control, and output rather than input based. Using output rather than input based metrics is consistent with the European Commission Performance Review Body's white paper on RP3 performance objectives[2].

Resilience

We agree with the CAA that resilience, both technical and operational, is fundamental to ensuring capacity performance. Customers have made clear that delivering a resilient and high quality day to day operational service should be one of our top priorities for RP3. With this in mind, and given the findings of the Project Oberon investigation, ensuring a robust level of technical and operational resilience will be a core requirement of our plan.

We note the CAA's expectations for NERL to "develop the means to perform a capacity oversight, assessment and advice function". This forms part of our work with the Voluntary Industry Resilience Group (VIRG). We will continue to take account of relevant recommendations of the VIRG in developing our initial Business Plan. However, we should not be held accountable for issues which are outside of our control. For example, while we can offer advice and re-routes to airlines, we have no means to enforce our recommendations, nor do we have means to manage combined airport schedule decisions which can cause significant traffic peaks in the network.

Environment

Our core plan will aim to improve flight efficiency mainly through delivery of LAMP 2 as the NATS element of the wider Future Airspace Strategy (FAS) Implementation programme. However, this will

[2] p44, "White Paper – RP3 Performance Objectives", Performance Review Body, 6 June 2016

need wider industry input and commitment to realise the full benefits. This includes fully formed airport requirements, together with the Government's active sponsorship and, where necessary, enforcement.

We intend to implement a refined 3Di metric that measures impacts that are fully within our control (eg removing the impact of runway direction, the effect of radar tracks not within our control (eg EFPS data from Newcastle Airport), the effect of extreme weather days (thunderstorms), and the effect of customer choices). This will enable us to identify and target improvements and to improve the service delivered to our customers.

As a core requirement, the CAA states that where possible NERL should reduce noise experienced by overflown communities. This is mainly outside our control, as we are unable to control the number of aircraft that fly, the noise produced by each, and because the majority of noise impact is driven by airport approach and departure procedures which are offered and owned by airports, and selected by airlines.

However, we can work with airports to design en route airspace in ways that help to 'distribute' noise in a way that can potentially reduce the impact on overflown communities (eg by introducing new respite routes). We would like to highlight that changes to routes are generally the result of an airport decision, and are not controllable by NERL. Therefore, our initial Business Plan will focus on managing noise in line with DfT guidance and the CAA's Airspace Change Process. While such solutions can reduce the impact of noise on overflown communities, the overall effect may actually increase the number of people overflown. We are also working to develop a formal process by which we can show we are managing noise impacts effectively.

We note that there may be new policy and regulatory requirements set during RP3 which we will need to meet. At this stage we are unable to outline our plans as the requirements (and associated systems, processes and costs) are unknown. Therefore, they will not form part of our core plan and will be costed separately.

<u>Airspace</u>

Our early discussions with customers have highlighted that airspace modernisation, and in particular LAMP 2, is their single largest priority in RP3.

We agree with the CAA that LAMP 2 will be a challenging and complicated programme and is likely to require decisions about the competing priorities of London Airports for airspace.

We will play an active role in areas where NERL is accountable and has effective control, bearing in mind that the delivery of LAMP 2 and other airspace modernisation changes is dependent on a large number of stakeholders including airports.

With this in mind, and to ensure that our customer consultation in summer 2018 is as relevant and meaningful as possible, we recommend that the CAA's Customer Consultation mandate invites airports within the scope of the London Approach to attend a separate session focused on airspace changes within the South East of England.

In general, leadership from the CAA and DfT, together with commitment and tangible action from broader stakeholders, is essential to help us ensure that airspace changes are made to a common plan, and to make decisions where there may be disagreement among stakeholders.

If supported by customers we could take on a greater coordination and delivery role. However, this would not form part of our core plan and would need to be separately costed. The role is not, and should not form part of our Licence obligations, given that airspace change requires support from all stakeholders, and irrespective of our approach, we have no way of ensuring we can fulfil such an obligation.

Cyber security

We expect our core plan to contain the resources required to ensure a level of cyber-security which is appropriate for our safety-critical operation. This will include meeting appropriate international and national standards, including the European Network and Information Systems Directive as currently understood.

New technologies

We note the requirement to provide outline technology (and airspace) plans to the CAA by 30 June 2018 ("Condition 10 plans"). These will follow the format, style and structure of the RP2 detailed technology and airspace programmes that were delivered to the CAA in March 2017, and which met the expectations of our customers, CAA and the independent reviewer. Our initial Business Plan will describe the content of the Condition 10 plans at a high level, while the Condition 10 plans themselves will provide further detail.

Further comments on the RP3 capex programme are provided under questions 4 and 5.

Drones

We are pleased to note that the CAA views drones as a core requirement for RP3. Our initial Business Plan will assume compliance with EASA requirements.

We note that the CAA is expecting to work with the Government to establish clearer guidelines on airspace management in relation to drones to ensure the safety of airspace users. Any requirements which are placed on NERL as a result will be considered as a 'trigger', since the scope and cost of activities which NERL will be required to undertake is not yet known.

Consideration needs to be given to the charging principles of providing an air traffic management service relating to drones. Where costs are incurred to ensure commercial airlines continue to receive a safe service, it appears appropriate to be remunerated through the relevant charges. However where we are required to provide access to airspace for drone users, this mechanism would be less appropriate. We would appreciate further regulatory guidance from the CAA in this area.

Performance metrics

Our view is that the existing capacity metrics have worked well as they allow direct comparison to other service providers, and are based on a well understood and standardised set of independently collected data. The metrics ensure that we focus on minimising delays which have highest impact on our customers and the travelling public.

In order to ensure the metrics are fair and representative of what is wholly within our control, we will propose adjustments to existing metrics, for discussion at the customer consultation.

Our comments on 3Di and more granular performance metrics (eg in London Approach) are provided above. Comments regarding performance incentives are provided under question 3.

3. Are there any further views from stakeholders on extending the scope of the incentives on NERL to put greater emphasis on resilience and noise?

As explained in our response to question 2 above, ensuring a robust level of resilience will be requirement of our core plan, taking into account the resilience requirements described in CAP 1512 (Proposals to take forward the NATS Independent Enquiry recommendations with regards to resilience). It would not be appropriate to establish additional targets or incentives on resilience as this would amount to regulating inputs as well as outputs.

As explained in our response to question 2, while we can help to manage the distribution of noise we cannot control the absolute amount of noise. Therefore, we do not consider it appropriate to incentivise this area.

Further comments on incentives are provided under question 8.

4. Is the broad approach to the draft business plan guidance on costs reasonable and is there additional third party assurance that NERL could reasonably provide to help demonstrate its forecasts of costs are efficient?

Customer feedback from our bilateral meetings in the summer of 2017 highlighted the importance of ensuring good levels of day to day operational performance, with adequate levels of resilience, and meaningful progress in modernising airspace to provide capacity in RP3 and beyond. We agree with this and accordingly our plan will be safety and service led.

We believe that cost efficiency should be assessed in the context of these priorities in contrast to an alternative approach which ranks cost efficiency above service delivery. A pure focus on cost efficiency fails to recognise the total economic value that we provide to our customers in terms of the considerable value of on time service performance, and the disproportionate cost of disruption for the travelling public associated with industrial unrest. With this in mind, an efficient regulatory settlement should not focus solely on minimising NERL's direct costs for the required level of service, but should seek to maximise the net benefits to our customers and the travelling public. Therefore, and given the large and asymmetric costs of delays, the regulatory outcome should include a margin to ensure resilience.

In answering this question, we comment on each of the key areas covered in Chapter 3 of CAP 1593.

<u>Capital expenditure</u>

We have taken account of the Helios/Arup recommendations, and have provided transparency of costs, improved visibility and granularity of benefits and outputs, and evidence around investment cost efficiency through our recent SIPs and the RP2 detailed airspace and technology programmes. We will continue to do so in our outline RP3 plans, and in our initial Business Plan.

The CAA states that it expects improved visibility of benefits and outputs, enabling the incremental impact of programme/sub-programme/project elements to be better understood. While this approach is relevant to some non-core elements of our plan, it does not lend itself well to assessing some investments contained within our core plan, many of which are critical to sustain systems and/or replace obsolete systems in order to continue providing the day to day service. Their fundamental benefit is enabling air traffic services to be provided in fulfilment of our licence obligations. We highlight this point to set expectations.

Where investment is essential to meet mandatory performance and international, regional and/or domestic obligations and standards, we will present customers with the most cost-effective solution to meet requirements. The investment case will focus on our cost effectiveness rather than justifying the benefits.

In terms of providing third party assurance that our costs are efficient, we continue to ensure value for money through competitive tenders and where long term projects are in existence, effective contract management. In addition, we also benchmark the effectiveness of our procurement processes. We will be happy to provide detail on these processes to our customers as part of the consultation and/or through the continuation of our SIP 'Deep Dive sessions'.

In our view, the upgraded SIP process appears to be working well as evidenced by the positive feedback we received for our most recent SIP18 consultation. We think that this now provides the expected level of transparency and granularity without becoming onerous for customers or ourselves.

In terms of the Independent Reviewer, we would like to highlight that the existing stated purpose of the Independent Reviewer is to provide assurance to CAA and to customers that our reporting of progress is accurate. We would not support an extension of scope (whether formal or informal) resulting in the Independent Reviewer becoming involved in investment planning and programme execution, which NERL is accountable for.

Operating costs

We note the CAA's expectations to provide an appropriate level of evidence that our cost forecasts are efficient, including estimates of costs associated with activities allocated to the wider section of the business plan. This includes strategic optioneering and cost benefit analysis of programmes and/or individual projects. However in some cases it may not be possible to provide full cost views of all elements of the 'wider' plan. For example, with respect to drones, requirements will be highly dependent on how the market changes or grows. Similarly, the cost implications of Brexit on NERL will be dependent on the eventual outcome.

As with capex, we highlight that some opex costs are critical to providing a continuing service in fulfilment of our licence obligations.

In our initial Business Plan, costs will be allocated to opex or capex based on our best current plans to deliver a project. As we are planning up to seven years ahead, it is possible that alternative ways to deliver a project will become available which are more efficient and which would deliver most value for customers. Allowing a degree of flexibility to switch between opex and capex, subject to customer consultation (eg via the SIP), would enable this. We would like to explore workable mechanisms further with the CAA.

In line with best practice, and with regard to the complexities and dependences within our service improvement and evolution programmes, allowing for operating cost contingency is critical. Previous experience has shown this is important, eg changes to our RP2 investment programme, driven by changes in the external environment, has led/will lead to significant additional training costs and dual running costs being incurred – which were not included in revenue allowances. Therefore, operating cost contingency allowance will enable NERL to respond quickly to changes in the external environment and meet customer requirements.

We note that the scope of the operating cost contingency (which covers all elements of opex) is wider than the FAS Facilitation Fund (which tends to focus on airspace modernisation and technical enablers). Our comments on the FAS Facilitation Fund are provided under question 7.

Pensions

Our comments on the CAA's guidance on pensions are provided under question 9.

5. Should the business plan set out information to facilitate the ex-post efficiency reviews of RP2 capex (which could include the disallowance of inefficient expenditure from NERL's RAB) or would these reviews be best carried out by a separate process?

In our view, ex-post efficiency reviews of RP2 capex should be conducted by the Regulator with support from consultants as required. This is because of the highly technical and specialist nature of the programme, the confidential commercial information relating to it, and the skills and experience required in making this assessment. Our comments on the CAA's consultancy study on capex are provided under question 16.

The extensive information already provided to customers as part of the SIP process, including their feedback, provides a useful context for the ex-post efficiency review of RP2 without the need for further information in our initial Business Plan.

6. Is the above draft business plan guidance on transparency of NERL's capital programmes and projects fit for purpose or could it be further improved?

The CAA suggests that we consider providing "clear traceability from programmes to individual projects". Given that the plan horizon will be up to seven years (two years remaining in RP2 and five years in RP3), realistically we will in many cases only be able to plan at programme rather than individual project level. This should be sufficient to provide enough transparency and granularity to assess the need for the investment and the relative costs and benefits. Information at project level would be provided through the ongoing SIP process when project plans become mature.

Please see our comments under question 4.

7. Is there stakeholder support for the continuation of the FFF? If so, do the current governance arrangements remain appropriate for RP3? Should we give further business plan guidance to NERL on the FFF arrangements?

We support the continuation of the FFF and believe it should be a component of our core plan. The benefits of the FFF are that it provides flexibility for NERL to respond to changing industry conditions and customer requirements/priorities in a cost efficient manner (ie costs are only incurred with prior agreement from customers/CAA and any unspent funds are returned in a net NPV-neutral way). An alternative approach would be the removal of the FFF. However, this would require us to include a higher contingency for risk at programme level which would not be as efficient from a customer viewpoint.

In our view, governance of the NERL component of the FFF could be simplified eg by adjusting the level of detail required to support business cases so that it is proportionate to their value.

We support retaining the 'Small Gaps' component of the FFF as a stimulus for implementing FAS. However we believe it would be more appropriate for this to be funded via the DfT/CAA element of the unit rate. If it continues to be funded via the NERL-element, we request that it is exempt from performance targets (as it is not within our control to reduce this element of the cost base).

8. Should we provide further business plan guidance on expenditure governance arrangements and/or incentives?

We note that CAP 1593 does not offer any business plan guidance on expenditure governance arrangements. We strongly believe that once the price control is set, NERL should be accountable for delivering the agreed upon targets and outcomes. If the CAA/customers seek to govern our inputs and processes then this will undermine our corporate and Licence accountabilities and our ability to deliver the performance plan ie the situation will become confused and unmanageable.

In terms of financial incentives, we support symmetric incentive schemes, where an appropriate percentage of revenue is at risk. We believe 1% per KPA (not metric) is suitable. It general, incentive mechanisms should be in line with European Regulations, and consistently applied. Any modifications to the current framework should be reflected in our cost of capital.

The data underpinning metrics used to calculate financial incentives must be reliable, with appropriate retrospective adjustment mechanisms. For example, in RP2 the Network Manager has been unable to remove A-CDM delay from ANSP-attributable delay, despite acknowledging that this should not be borne by ANSPs.

As per our letter of 12 September 2017, for the purposes of developing our initial Business Plan we are assuming that there is no change from the current incentives framework. If the CAA is contemplating any material change then our request is to have due notice of this in order that we can adjust our plan and consult on it accordingly.

9. Is the draft guidance set out above on pensions reasonable and can it be improved?

We welcome the CAA's recognition of the link between Trustees' confidence in the regulatory framework and the level of pensions costs. We agree that were Trustees to lose faith in the regulatory framework, then their assessment of risk would rise and they would be likely to adopt a more cautious approach to pension deficit recovery, investment strategy and to their wider assumptions, leading to higher costs in RP3.

With this in mind, we think that all stakeholders would benefit from the CAA further developing and clarifying their regulatory approach to the remuneration of pension costs, as this could provide Trustees with increased assurance around the longer term strength of NERL's covenant.

This would help ensure that charges reflect pension costs which are as efficiently incurred as possible.

10. Is the draft business plan guidance on the cost of capital, regulatory depreciation and financeability appropriate?

In answering this question, we comment on each of the key areas listed in Chapter 4 of CAP 1593.

Cost of capital

We agree that the WACC should compensate NERL for the business and regulatory risks we face, and that our business plan should identify a balanced set of proposals for incentives that promote efficiency but also do not unduly increase risks and financing costs.

We note the CAA's comments in relation to NERL having regard to the information on market wide elements of the cost of capital, and the early and preliminary range for Heathrow Airport Limited's WACC that will be published in December 2017. We will take note of these in framing our own proposal in line with the CAA's request that we own all assumptions.

NERL will give consideration to the treatment of differential risks associated with the core and any wider sections of its business plan. This will include consideration of whether they are appropriate risks to include in the assessment of WACC or whether it is more appropriate that compensation for these risks should reside within other elements of NERL's Determined Costs.

In our initial Business Plan, we will set out how we've reached our proposed cost of capital, and will be happy to talk customers through this. However, determining the cost of capital is ultimately a regulatory decision. We expect the CAA to undertake a detailed review of our evidence in coming to a decision.

Regulatory asset base and regulatory depreciation

We welcome the CAA's invitation to consider how the one-off fall in depreciation 2021 caused by assets at privatisation becoming fully depreciated should best be addressed in our initial Business Plan. We will set out our recommendations for consideration.

Assessing financeability

We will assess the financeability of the core component of our initial Business Plan and its capacity to withstand a credible range of downside scenarios. Our ability to assess the financeability of any wider element of the plan will be dependent on having mature requirements and cost estimates and in developing regulatory mechanisms for their remuneration. We will highlight these issues.

We agree that the financeability assessment should be framed within rating agency guidance on credit ratings derived from credit metrics. However, we also consider the credit metrics specified under our existing debt covenants, as these are relevant in ensuring NERL is financeable during RP3.

CAP 1593 is silent on the nature, timing and extent of the CAA's own financeability assessment. For this reason, we would find it helpful for the CAA to confirm that it will be performing this taking into account limitations faced by NERL in attracting and providing new equity.

11. How should we best include airports in the scope of the Customer Consultation mandate?

During summer 2017, we held bilateral meetings with airports, as well as with our airline customers. The aim was to understand priorities for RP3 so as to reflect these in our initial Business Plan. This approach was well received.

As described under our response to question 2, we propose to seek the views of airports on relevant topics including areas where there are dependencies on activities at airports. This will include the airspace modernisation component of our capital investment programme and our traffic forecast assumptions.

12. What steps should NERL take to reflect the views of wider stakeholders, such as passengers and overflown communities, in the development of its business plan?

<u>Reflecting the views of overflown communities</u>

As explained in our response to question 2, we make every effort to manage the impact of noise on local communities, especially when this is a result of airspace change. Since this also requires input from many other stakeholders, we believe that meaningful consultation and engagement with overflown communities is best carried out via the new airspace change process.

We can also build on this by involving overflown communities at an early stage of any proposed airspace change proposal or sensitive operational change, proportionate to the likely impact of the change, through our community engagement strategy which is our means of identifying and addressing matters of interest to overflown communities. We do not consider it appropriate or relevant to engage directly with overflown communities on the development of our initial Business Plan.

<u>Reflecting the views of passengers (in particular on resilience)</u>

We will continue to describe our investments and plans to modernise airspace and technology publicly on our nats.aero website.

Airlines are best placed to understand and respond to the priorities of their customers, the passengers. Therefore, we consider that airlines will reflect the views of passengers during the customer consultation process. For this reason, we do not propose to engage directly with passengers on our initial Business Plan.

13. Should the customer consultation process follow the same broad approach as RP2, with a requirement for a structured engagement programme, customer consultation working group and an independent/joint chair?

During our bilateral meetings with our customers over summer 2017, we sought feedback on the approach to customer consultation in RP2. Customers we spoke to responded positively to our recommendation to retain a customer co-chair and similar structured engagement programme and working arrangements for RP3.

Subject to other feedback to CAP 1593 we would be happy to engage with the CAA in developing the Customer Consultation mandate, incorporating any suggestions for improvements made by respondents.

14. What topics should the customer consultation programme address and what improvements can be made compared to the process for RP2?

We have already held a series of bilateral meetings with airlines and airports to discuss their priorities for RP3 and the customer consultation process. This early engagement already represents an improvement in process compared to RP2, as it allows even earlier identification of customer requirements as an input to our initial Business Plan.

Before launching the consultation, we recommend having a teleconference with customers and including the CAA to ensure alignment on the practical consultation working arrangements.

Our candidate topics for the consultation programme include the following:

- Our understanding of key customer requirements;
- Our plan assumptions, including traffic projections;
- Proposed performance targets;
- Our investment portfolio, including airspace modernisation activities, technology programme and plans for service evolution;
- Costed plans with indicative price profiles, based on different scenarios.

15. Are there alternative model(s) of customer consultation that might be followed for RP3 – bearing in mind the constraints created by needing to align the timetable for customer consultation with the SES Performance Scheme and associated milestones.

In framing this question, the CAA highlights an important point, namely that its domestic timetable as outlined in CAP 1593 does not align well with the timetable of the SES Performance Scheme. Our current understanding is that the European RP3 regulatory framework is scheduled to be agreed in March 2018 (too late for our initial Business Plan), with EU-wide targets being agreed by December 2018 (too late for our revised Business Plan).

Therefore, we would encourage the CAA and the DfT to engage with the Commission on both the development of the RP3 framework and relevant EU-wide targets which could impact NERL. In regard to the latter, we suggest that the aim would be to inform the Commission of the customer requirements that become evident prior to and during the customer consultation process in order that these can be taken full account of by the Commission in target setting. This would minimise the risk that NERL's plan would be materially misaligned with the Commission's targets.

In process terms, NERL's revised Business Plan will need to take account to the extent possible of any changes in the European RP3 framework. Also, there could be a need after this plan has been submitted to consider further revisions once the EU-wide targets are known.

16. What views do stakeholders have on the proposed CAA consultancy activities as discussed above and set out in Appendix D – in particular the nature of the proposed studies, their objectives, scope and deliverables?

Before commenting on the nature, objective, scope and deliverables of proposed CAA consultancy activities, we would like to request the following:

- The appointment of consultants with sufficient expertise and experience in performing the study and, where possible, with relevant knowledge of the ATM sector and our regulatory framework. While the cost is a relevant selection factor, this should not be at the expense of quality.

- Terms of reference which provide guidance on arrangements for protecting confidential information (eg in accordance with the Data Protection Act), for secure file sharing, efficient ways of interacting with NERL eg consultants setting out initial questions ahead of face to face meetings, and adequate time for fact checking.
- Appropriate phasing of studies taking into account when information will be available given NERL's internal governance processes eg Board endorsement of the initial Business Plan at the end of March, and demands on NERL's staff to engage with consultants and to fact check reports.

We would be happy to provide input on these areas when the CAA is ready.

We would support the CAA's use of consultants if required, to review other elements of our initial Business Plan, eg for areas where the CAA may not have the required technical expertise.

<u>Cost allocation</u>

We request that the draft specification for this study should clarify that its scope does not extend to costs and pricing relating to NSL's own commercial arrangements with customers other than NERL.

<u>Non-staff opex review</u>

We request that the draft specification for this study should be expanded to include the following:

- Consideration of inter-dependencies with staff operating costs, for example where work has been outsourced to deliver savings;
- Consideration of new service models which NERL may wish to follow. For example, in IT, NERL may wish, or be compelled, to subscribe for data services (which increase opex) rather than own these as a way to provide better value for money to customers by reducing the total cost (opex and/or capex);
- Consideration of non-staff opex to support the delivery of NERL's Deploying SESAR programme, eg dual running of systems for a transitional period of time, which is necessary to modernise systems and enable airspace changes in the South East of England;
- Consideration not only of comparisons to previous years plans and actual cost, but also of costs relating to future requirements;
- Consideration of the changing external environment, eg cyber-security requirements which were not in place during the development of the RP2 plan, or costs required to support continued traffic growth;
- Consideration of performance since privatisation in 2001, and comparisons to other privatised/liberalised industries.

<u>Staff opex review</u>

We request that the draft specification for this study:

- Has as its general scope the need to consider whether proposed staff costs are efficient and achievable in the context of the plan requirements and targets around safety, capacity, resilience, environment, airspace change, new technology, cyber security etc. This is a broader description than the current description and aims to make the linkage between requirements and efficient costs clearer;

- Excludes pension costs (and pension cash alternative) from the study scope as this is covered by the separate study analysing pension costs;
- Includes consideration of suitable benchmarks for job matching which capture the effect of the highly skilled (but not academic) and specialised labour market for ATCOs and other operational staff taking into account their important safety responsibilities;
- Considers both the level of compensation costs and the growth rates of staff pay in NERL's business plan in the context of the legacy industrial relations at NERL. In particular, the study should consider the most efficient pay practices in heavily unionised industries with collective bargaining;
- Ensures that the assessment of efficient staff costs has due regard to the need to ensure a well staffed operation with the resilience that customers expect along with the capability to deliver important airspace changes and the technology programme, as well as the need to address emerging requirements (eg cyber-security);
- Examines the efficiency of staff costs in the context of the long recruitment and training cycles that NERL faces. Long training and recruitment cycles require NERL to invest in ATCO training and retention years ahead of air traffic in order to provide a resilient service if that demand materialises;
- Assesses efficiency taking account of all relevant dimensions which drive costs including staff retention, recruitment costs, sickness and training, as well as pay. Undue focus on one of these dimensions to the exclusion of others could lead to an assessment which could fail to take account of the wider benefits that customers receive or of costs avoided;
- Specifies the use of a transparent database, so that NERL is able to review any analysis provided by the CAA's consultant;
- Considers performance since privatisation in 2001, and comparisons to other privatised/liberalised industries.

<u>Capex review</u>

We request that the draft specification for this study:

- Includes a requirement for the ex-post review to compare delivery of planned benefits and costs against NERL's re-baselined plan and timetable presented to customers in SIP17 and our detailed RP2 technology and airspace programmes (March 2017);
- Phases the review of RP2 capex spend separately from the review of our proposed RP3 capex programme. This would enable the ex-post review to take place closer to the end of RP2;

<u>Cost of capital review for NERL</u>

We request that the draft specification for the fuller study that will be commissioned at a later stage should clarify that:

- In assessing relevant market evidence regard must be given to long run historical averages of total market return;
- Regard should be given to best academic practice (alongside regulatory precedent which is already mentioned);
- Estimates of individual parameters should be rooted in empirical evidence.

Review of NERL pension costs

We have no further comments on the scope of this study.

Other comments

Technical assumptions

In our letter to the CAA of 12 September 2017, which pre-dated CAP 1593, we set out the assumptions upon which we propose to base our initial Business Plan.

We have noted that the CAA would like us to own and justify our assumptions. Notwithstanding this, and as explained in our introduction, there are a number of important assumptions upon which we would request regulatory guidance and/or assurance:

- London Approach charges – the method and scope of operation, structure of charges and calculation methodology, service quality incentives (see our response to question 2), cost of capital and calculation of Regulatory Asset Base. We describe this in more detail below.
- Pensions – the calculation methodology and assumptions, retention of pension pass through via costs exempt from risk sharing, allowance for projected cash contributions and pension compensation allowance. This is described in more detail in question 9 and below.
- Capex – our initial Business Plan will assume that pass through of RP2 capex is allowed where NERL meets customer consultation and efficiency tests, and that the pass through mechanism will remain unchanged.
- Traffic risk sharing – our initial Business Plan will assume that the existing traffic risk sharing mechanism will continue to apply.

Any changes to the regulatory framework regarding capex, pensions and traffic risk sharing should be reflected in the cost of capital calculation.

In relation to the remaining assumptions in our letter of 12 September 2017, if the CAA does have concerns on any of these then we would appreciate timely feedback from the CAA. Otherwise, and unless we have described a different approach in this response, we will continue on the basis outlined in our letter for our initial Business Plan.

London Approach

In paragraph 2.6, the CAA states that NERL should review the scope of the London Approach service, and whether there have been any developments since the last regulatory review that would merit further consideration.

We note that the CAA last reviewed the scope of the London Approach service in 2014 for RP2 (CAP 1158, February 2014). At that time, since the CAA was not minded to make significant changes to the London Approach charge for RP2, the CAA concluded that "there does not appear to be any implications for existing contracts". Therefore, the CAA stated that it still held its 2010 view that there was not a good case to increase the scope of the London Approach charge to cover Biggin Hill and other small airports in the London TMA given the small scale of operations at that airport compared to other airports within the London Approach service (CAA price control proposal 2011-2014, May 2010)[3].

[3] May 2010, http://webarchive.nationalarchives.gov.uk/20140801110022/http://www.caa.co.uk/docs/5/ergdocs/20100527NERLCP3Proposals.pdf

We agreed with the findings of the CAA's assessment at that time, and as the scale of operations at Biggin Hill and other small airports within the London TMA remains small compared to airports within London Approach, we do not consider that a change in the scope of London Approach is required on the basis of the criteria set out previously by the CAA, absent modification to the London Approach charges (see below). However, we are aware that Biggin Hill has expressed a strong interest in being included within London Approach and therefore we would encourage the CAA to consider the merits of this case and to provide us with regulatory guidance.

In paragraph 2.5 the CAA states that it expects NERL to consider allocation of costs between London Approach and En Route. By this, we believe you mean there should be consideration of the price rather than the cost allocation, as it is well known by the CAA and our customers that the price charged is not fully cost reflective. Note: the cost allocation between London Approach and En Route follows the cost allocation principles previously reviewed by the CAA and its consultants.

The principles applied to determine the London Approach charge were subject to CAA review and consultation in 2014. At that time, the CAA stated that it would be inclined to move towards a London Approach charge which is fully reflective of the costs incurred over time, in line with a common approach across the EU[4]. In the absence of any further guidance from the EU and CAA, and any representations from our customers for change, we will maintain the same level of cost reflectivity in the prices charged in our initial Business Plan. We will continue to deduct the current allocation of London Approach revenues from our En Route cost base via the single till mechanism.

As this is an area where the CAA has a leading role we would invite the CAA to provide regulatory guidance if it considers that change is necessary.

Our comments on more granular service quality measures within London Approach are provided under question 2.

<u>Met Office services in RP3</u>

Met Office forecasters are currently providing a service to the UK network from our Terminal Control Centre. This is a valuable service which we expect to continue in RP3, funded as part of the Met Office's component of the unit rate together with improved forecast data sharing with the industry. This would offer increased transparency for customers, compared to the current situation in which the service is funded via the NERL element of the unit rate and should be consulted with airlines, NATS and airports in the lead up to RP3.

Areas for regulatory guidance/assurance

As explained above, we believe that regulatory guidance is required in the following areas which naturally fall within the CAA's domain as the economic regulator of NERL:

- The scope of London Approach (if CAA considers that modification is required);
- Principles to determine the London Approach charge (if CAA considers that modification is required);
- Charging principles to be applied to the provision of an air traffic management service to drones and other unmanned air traffic.

In addition, we require regulatory assurance on the following assumptions, which are material to our plan, to avoid significant late re-work or changes:

[4] In its 2014 review, the CAA noted that the arrangements to allocate equivalent costs taken across the rest of Europe varied, and in some cases the costs of the services may be borne by those not using the services.

- Retention of pension pass through (costs exempt from risk sharing) mechanism;
- Retention of existing capex pass through.

Timely feedback from the CAA in these areas is required to ensure we have a stable framework to develop our initial Business Plan for effective customer consultation (ie without revisions midway through the process to reflect material changes). Therefore, we request the CAA's feedback in these areas, and, if the CAA has concerns, on the other technical assumptions set out in our 12 September 2017 letter, by Monday 4 December.

Proposed next steps and timetable

Subject to receiving the guidance and assurance described above in a timely way, we propose the following next steps and timetable for the CAA's consideration:

- Submission of our initial Business Plan: We will submit our initial Business Plan to you in early April 2018. This will enable our Board to scrutinise and approve our plan at its end of March meeting before submission.
- Customer consultation: Customer consultation is likely to begin in late April/early May 2018, although (as described in question 14) we plan to hold a pre-consultation teleconference beforehand.
- Submission of our revised Business Plan: We plan to submit our revised Business Plan to the CAA in early December 2018. This is to allow sufficient time to fully reflect on the outcomes of the customer consultation (which is likely to complete in September 2017), and to allow our Board adequate time to review and scrutinise the revisions at its end of November meeting.

We would be happy to meet with you/your team and with any consultants who may be assisting you with your RP3 work programme to discuss this response further.

Yours sincerely,

David Phelps
Deputy Head of Regulation