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Consumer and Markets
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Luton, August 4, 2023

easyJet response to the Civil Aviation Authority 's Provisional Decision (CAP 2553)

Dear Mr Carter,

easyJet welcomes the opportunity to submit written comments on the CAA's Provisional Decision for the next price control review (NR23) set out in CAP 2553.

We support the CAA's balanced approach in its assessment of NERL's NR23 Business Plan. From a cost perspective we note the significant improvement from the original Business Plan proposed by NERL, in terms of a reduction in Determined Costs and a more sustainable distribution of the Traffic Risk Sharing (TRS) Debtor. However, we would like to reiterate that airspace users would still be subject to a significant increase in unit rates (URs) in NR23 from current levels. Although easyJet generally supports the Provisional Decision, we reiterate that such increases are not justified by a proportional increase in service performance and that further improvements should be sought to bring charges closer to true affordability.

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

1. Traffic assumptions

We note that the CAA considers that it should continue to use STATFOR forecasts, using the most recent available forecast, as this is an independent and reliable source of forecasting. The CAA used the March 2023 medium-term base-case forecast from STATFOR for its Provisional Decision. We support the use of such forecast for traffic volumes to calculate the prices that NERL can recover from its airline customers, as this is both transparent and consistent with RP2, RP3 and NR23 Initial Proposals. NERL operational resourcing plans should also be adapted accordingly, to ensure appropriate levels of service in the event of higher traffic than the one proposed.

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

Our stance remains unchanged: airspace users should not bear the burden of financing NERL's losses from 2020 to 2022, as the decrease in air traffic resulted not from commercial airline decisions, but rather from policy responses to a global pandemic.

We appreciate that the CAA has limited scope for supporting other non-regulatory ways of financing the TRS Debtor and we support the efforts the CAA made so far to ease the burden on airspace users. However, the CAA has the opportunity to further reduce that financial burden by not including the TRS debtor amounts in the RAB through the working capital. In fact, the CAA suggests that the TRS revenue shortfall will be accounted for in NERL's RAB for stability of the regulatory framework and financeability of safe and reliable operations.

The treatment of the TRS revenue shortfall within the regulatory framework has already been appropriately modified by the CAA in response to an emergency situation to help achieve the objective of affordability of charges. The exclusion of the TRS revenue shortfall from the RAB would aim at achieving the same objective within an already modified framework. We also do not have evidence that the exclusion of an additional earning from the revenue losses of 2020-22 for NERL through the WACC could mine its financeability capabilities. These amounts are also proposed to be recovered adjusted for RPI inflation during NR23. The proposed solution is turning a loss into an asset and a consequent additional inflation-adjusted profit for NERL.

This loss is the result of the business risk which NERL, in the same way as any other economic entity, has to face. This is why NERL is allowed a regulatory return based on its risk profile and derived from the WACC. It is not clear what business risk the WACC of NERL aims to capture if an essential facility is permitted to benefit from losses. Finally, allowing NERL to profit TRS Debtors would potentially undermine an important incentive for efficient cost, in contrast with the principles set out in TA00.

In absence of an assessment by the CAA on the efficient cost baseline during traffic downturn periods, the more inefficient NERL's costs are, the higher the regulatory return it can expect to gain from the inclusion of the TRS Debtor into the RAB through the cost of capital.

3. NERL's costs

The CAA's primary focus should be on incorporating efficient operating expenses into the NR23 price control while also motivating NERL to enhance its efficiency over time. This approach aims to foster consumer benefits and productivity levels that align with those anticipated for an efficient market operator (in lieu of a competitive market), fulfilling the obligations in TA00. Overall we support the work that has been done by the CAA to assess and establish allowances for NERL's Determined Costs for NR23.

3.1 Inflation

We disagree with the assumption that NERL's costs will be linked to CPI inflation when looking over the whole NR23 regulatory period. A significant proportion of costs that do not move at the same rate of CPI's forecast (including staff costs, which are not linked to inflation indexation by contract, and pension costs, together representing more the vast majority of NERL's OpEx). The CAA should establish cost allowances for an efficient market operator in a competitive environment, anticipating that NERL will have the capacity to minimize the impact of inflation, preventing the complete pass-through of any increase in CPI in its cost base. NERL should have appropriate incentives to enhance its efficiency throughout NR23.

3.2 Staff Costs and Productivity

For the reasons expressed above, we do not support the projection of a CPI+0.25% pay increases on average for all staff over NR23, while we would assume a slower wage growth in NR23, in line with CPI. The cost allowances should strike a balance between attracting staff at the necessary and efficient level without resorting to excessive compensation beyond market rates.

We support the CAA's assumption that NERL should be able to achieve productivity growth of 1.5% for operational staff per year from 2025 onwards, as it seems a reasonable assumption from the Steer report. The historical data and the expected efficiency gains from airspace modernisation programs and improvements to training and rostering support this view.

However, we note that to make a more confident judgement it is essential to gain a deeper understanding of the underlying CapEx and the latest traffic forecast, which might influence the Final Proposal price controls when the October 2023 STATFOR forecast is published. Once available, we expect that Egis' comprehensive review of the CapEx program of NERL will help stakeholders gain definitive clarity, while enabling the CAA to draw informed conclusions and develop appropriate targets.

3.3 Pension Costs

In light of the same principles expressed above, allowances for pension costs should be set at levels that are deemed reasonable and efficient. Correctly addressing such a significant portion of the cost base is of primary importance when setting NR23 cost allowances. easyJet welcomes the GAD review of NERL's pension costs and expresses its support for the CAA's decision to adhere to the Initial Proposals' estimations for the efficient cost allowances for UKATS pension costs in NR23.

4. CapEx

We reiterate that we consider technological upgrades and airspace modernization as top priorities for NR23. We have been concerned about the potential impact on consumers due to the reported increase in costs as outlined in the final iSIP22 document last January, as well as the ongoing delay in the DP En Route program.

We welcome the resolutive approach that the CAA took on the matter and we eagerly await Egis' assessment on NERL's NR23 CapEx plan. We are not in a position to comment in more detail on the CapEx plan under review until the assessment is published later this year. However, we hope the review will results in efficiency and productivity gains to users and a modern, suitable UK airspace that aligns with the industry's sustainability needs.

5. Traffic Risk Sharing during NR23

We note that the CAA maintains the general approach to the TRS mechanism for UK en route services, which was in place before the effects of Covid-19. However, the CAA has put forth a proposal that involves spreading the recovery of revenues over several years in cases of unexpected traffic reductions exceeding 10%. We support the intention of offering more predictability and minimising the impact of such traffic fluctuations on airspace charges in the event that actual traffic falls significantly below the assumed levels. We would also suggest, in line with the proposal for the Covid-19 related TRS Debtor, that the CAA assesses those possible losses based on efficient costs for traffic reductions above 10%. For any TRS Debtor arising from unexpected traffic reductions below 10%, we are confident that the CAA will set the right incentives for NERL to adopt only

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reasonable and efficient costs to safeguard consumer interests. This would require the CAA involvement in reassessing the efficient cost baseline and thus the price controls only during exceptional circumstances.

6. Cost of Capital

We maintain the view that NERL is a low risk business. NERL offers a service that serves the public interest and is entitled, as per regulation, to seek compensation for any revenue losses by applying for an increase in unit rates through the TRS mechanism. In our last submission we argued for enlarging the set of comparators to increase statistical significance and for using the Damodaran estimate for the equity market risk premium (ERP). We note that the CAA has not taken on our comments in its analysis, but overall we remain supportive of the estimation of the WACC that was undertaken in the Provisional Decision.

7. Service Quality

We welcome the CAA's proposal to maintain the same level of target setting ambitions in its Provisional Decision, in particular in the area of capacity, whose targets are more aggressive compared to RP3.

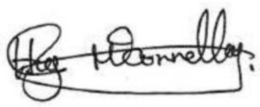
We would like to see environmental targets further improved, such as a 10% reduction in CO2 emissions by 2035, and work during NR23 to improve the 3Di metric for NR28, in order to better capture flight planning and tactical flight operations priorities.

8. New Airspace Users

During NR23, NERL foresees the emergence of new users for UK airspace, such as advanced air mobility. We agree with the CAA that the costs incurred by NERL in managing these new users should, in principle, be borne by them. We note that the CAA also mandates that NERL will be the responsible entity in consulting on a new charging mechanism that allows for the recovery of efficient and appropriate costs associated with new user services. We believe that the CAA should monitor (and consult on) these arrangements.

We are open to further discussions and clarification on the points raised before the finalisation of the proposal during 2023.

Sincerely,



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