British Airways plc
Waterside
PO Box 365
Harmondsworth UB7 0GA

Paul Smith
Consumers and Markets Group
Civil Aviation Authority

cc: economicregulation@caa.co.uk

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British Airways response to Civil Aviation Authority
Consultation on economic regulation of NATS (En Route) plc
Initial Proposals for the next price control review ("NR23")

Thank you for the opportunity to respond to your consultation on the Initial Proposals for NATS (En Route) plc ("NERL"); we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

We have endeavoured to deliver as complete a response as possible, given the tight timelines, and remain available for further engagement, either bilaterally or through consultation whilst the CAA further develops and refines its proposals.

Executive Summary

a) The Initial Proposals the CAA has published are based on the latest credible information available to the CAA at the time. Since the CAA formed the Initial Proposals, the external environment has moved on. **We urge the CAA to ensure it has taken the latest information available into consideration up to the point of publishing its final proposals**, including out-turn traffic, updated forecasts and macroeconomic developments.

b) We **welcome the CAA outlining more challenging service quality targets than those proposed by NERL** in its business plan, but the approach adopted by the CAA in relation to capacity targets appears too simplistic and requiring further consideration, set from the headline C1 metric, where **the CAA must be confident that it has appropriately calibrated targets to opex and capex investments as well as airspace changes**.

c) The CAA appears to have **fallen short of proposing a reasonable efficient baseline for NERL's operational costs in the period 2020-2022** and requires further adjustment to reflect the full extent of efficient cost levels. We **support recoveries to be made over a ten-year period, evenly split between NR23 and NR28 and profiled to present a flat price path in NR23**.

d) **Service quality incentives must be appropriately calibrated to the price control building blocks and reflect the benefits of these investments** both from future developments and also appropriately recognise those already delivered. We advocate for further assessment to be conducted and support the engagement of stakeholders in developing these proposals.

e) The CAA must **only include allowances for efficient operating expenditure in the NR23 price control, ensuring it has appropriately calibrated allowances across the price controls building blocks** and that NERL is appropriately incentivised to become more efficient over the course of the period, promoting consumer benefits and productivity **comparative to that expected in a competitive market environment**, fulfilling the CAA's duties as set out in TA00.

f) We advocate that the CAA should adopt allowances that **reflect wage levels and their growth that are in line with benchmarks**; wages should represent the efficient level required to attract the required levels of talent without over-rewarding in excess of market rates.

g) The application of higher ATCO productivity appears to require further assessment to establish the extent of, and utilisation of, benefits generated by investments and developments made by NERL.

h) We support the adjustment of graduate headcount on the basis that NERL's retention rate appears too pessimistic in comparison to market levels.

i) Pension costs have long been an area of great concern to British Airways. Over time the cost borne by airspace users to fund **NERL's incredibly generous and protected pensions costs has grown out of control.** Understanding that some historic pensions arrangements are protected we particularly welcome the CAA's indication of the need for the introduction of a new (less generous) DC scheme for new starters should be considered by NERL as part of the solution required to reduce the staff opex costs. British Airways urges the CAA to encourage NERL to seize this opportunity now and to **re-baseline pension costs for new starters** with a scheme that is not less efficient than comparator organisations.

j) We further welcome the advice and expertise of GAD in highlighting certain, more technical, concerns relating to the funding of pensions in the NERL BP (such as **adjusting funding levels** with the aim of **reducing the chance of creating a trapped surplus** and challenging some of the assumptions, such as the **discount rate** and **transition to the long-term funding strategy**, being used for funding post the next actuarial valuation from 2025 onwards). The subsequent reductions in the costs that you propose to be allowed to be passed through will reduce the size of the increase airspace users will see in charges at a time when recovery in traffic levels is still uncertain.

k) In the final proposal British Airways trusts that the CAA will have considered **all opportunities identified** to reduce the pension costs being passed to airspace users, such as:
- scheme management/administration costs;

- consideration of the suitability of mechanisms used by other regulators to reduce pensions costs;
- assumptions on the growth in pensionable pay (post expiry of the current cap);
- taking legal advice to understand the extent to which the NATS Section's provisions can be amended

l) British Airways **supports the reductions made to non-staff opex** in the initial proposal but wishes to further gain a better understanding of the efficiency (or otherwise) of the current implementation and deployment plan relating to DP En Route and the extended period of (and therefore higher costs associated with) **dual running** of legacy and new systems. Steer's ideas about an **alternative, potentially more efficient deployment plan certainly need to be explored** more fully prior to your final proposal.

m) **The capex plan holds reasonable strategic objectives, key to which is delivering the infrastructure requirements necessary for airspace modernisation**, however it **seems appropriate that the Capex plan is consulted on further due to a number of critical issues**; the lack of quality information shared by NERL to the CAA and customers to enable appropriate assessment, Steer's assessment suggesting a rebalancing of the plan between sustainment and modernisation could be more efficient, the significant increase in cost estimates and reprofiling of the DP En Route programme since NERL's business plan was published and NERL's ongoing investigations into its enhancing its delivery capabilities.

n) We **do not see the need for a TRS mechanism for Oceanic traffic** and remain **supportive of the need for a cost/benefit review of the introduction of SB ADS-B data charges** as well as the **development of targets to ensure full value from the technology** is permitted. We would welcome a better understanding of how both ADS-B data charges are determined.

1. Context and approach

1.1. NATS (En Route) plc, known as **NERL, is the monopoly provider of en route and certain approach air traffic services (ATS) in the UK** and is subject to economic regulation by the CAA under the Transport Act 2000 (TA00), which sets out that **the CAA has several duties to perform, primarily to exercise its functions in a manner to maintain a high standard of safety in the provision of ATS** alongside a series of subsidiary secondary duties[1].

1.2. Under its secondary duties the CAA must exercise its functions, amongst others, in a manner it thinks best calculated; **to further the interests of operators in regard of the availability, cost and quality of ATS, to promote efficiency and economy on the part of licence holders**, to take account of any international obligations of the United Kingdom and to secure that licence holders do not find it unduly difficult to finance activities authorised by their licences.

[1] https://www.legislation.gov.uk/ukpga/2000/38/part/I/chapter/I

1.3. **The TA00 sets out that the setting of price controls and service quality incentives for NERL is one of the CAA's core functions** and under its international obligations the UK is party to the Eurocontrol Multilateral Agreement relating to Route Charges[2] and has adopted the Eurocontrol common policy in respect of charging for en route services, as set out in the Eurocontrol Principles for establishing the cost base for en route charges and calculation of the unit rates[3].

1.4. Through its Initial Proposals[4], the CAA establishes its proposal for the UK en route, London Approach and Oceanic price controls applicable for the five-year period from 1 January 2023 to 31 December 2027, known as "NR23", and follows the Reference Period 3 (RP3) price control which apply from 1 January 2020 to 31 December 2022.

1.5. In establishing its Initial Proposals for NERL's NR23 price control, the CAA is setting **the maximum prices that NERL can recover** from its customers as per the terms dictated in its licence[5], and are formed from **allowances for efficient costs** and forecasts for traffic volumes.

1.6. We **fully support that the CAA's overriding priority for NR23, in keeping with its primary duty under TA00, is to ensure that NERL is economically regulated in a manner that allows for the continued provision of a high standard of safety in ATS in UK airspace** and that safety must always be protected, where necessary at the constraint of air traffic. We expect these proposals would enable NERL to at least maintains its current safety performance.

1.7. NERL holds a monopoly position due to an absence of effective economic competition in the provision of UK air traffic services and as a result **the CAA, under its secondary duties in TA00, must seek to protect consumers from the power of the monopoly, drive efficient outcomes in a manner akin to the competitive forces experienced in the open markets and avoid tending toward positions held by the regulated company,** neither as a result of information asymmetry, nor due excessive regulatory caution that is incomparable with dynamic and competitive markets.

1.8. We **advocate for the CAA to consider all relevant information and the latest evidence in developing its final performance plan**, including traffic performance and forecasts as well as the latest macroeconomic developments and forecasts

[2] https://www.eurocontrol.int/publication/multilateral-agreement-relating-route-charges
[3] Eurocontrol Principles for establishing the cost base for en route charges and the calculation of the unit rates
[4] https://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=11680
[5] https://www.caa.co.uk/media/azlfstks/air-traffic-services-licence-for-nats-en-route-plc-january-2022.pdf

Airspace Modernisation

1.9. The links and obligations maintained in the CAA's Initial Proposals between the Airspace Modernisation Strategy (AMS) and NERL's role in its delivery, including facilitating the Airspace Change Organisation Group (ACOG) function, are a key component of the NR23 period and reflect the position that airspace modernisation holds as a national strategic objective for the UK in its vision to "deliver quicker, quieter and cleaner journeys and more capacity for the benefit of those who use and are affected by UK airspace"[6].

1.10. In keeping with this strategic priority, it is imperative that through these proposals NERL is able to deliver on its obligations including airspace and technology initiatives; NERL should not be a hinderance to airspace modernisation when it occurs.

Traffic Forecasts

1.11. Traffic forecasts are **vital to the overall economics of the price control and to establishing the suitable allowances for operating and capital expenditure necessary for delivering appropriate service quality outcomes** by NERL as well as providing the divisor for the calculation of the unit rates.

1.12. Despite the significant suppression of demand experienced during the Covid-19 pandemic it is clear from the recovery of traffic over the course of 2022, with Eurocontrol reporting traffic levels have now reached 87% of 2019 levels in November[7] and with **UK average daily flights consistently achieving 87-89% of 2019 levels since May 2022**[8], that NERL does not now face any material remaining Government pandemic-related travel restrictions, and that **the drivers of traffic forecasts must be based upon underlying economics**.

1.13. We continue to **support the use of STATFOR forecasts**, it is appropriate to continue the methodology used at RP2 and RP3 **providing regulatory consistency** and continued alignment with Eurocontrol Principles, whilst also **ensuring that forecasts remain independent of the regulated company wherever possible**.

1.14. The use of STATFOR base case forecast is consistent with previous price controls and appears appropriate as the recovery in 2022 has demonstrated a close alignment to traffic recovery forecast in the October 2021 base case, which forecast 2022 UK IFR Movements at 89% of 2019 levels[9].

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[6] CAA CAP2394 p36
[7] https://www.eurocontrol.int/sites/default/files/2022-11/eurocontrol-comprehensive-air-traffic-assessment-20221125.pdf
[8] https://ext.eurocontrol.int/analytics/saw.dll?Dashboard UK state, exported 29 November 2022
[9] https://www.eurocontrol.int/publication/eurocontrol-forecast-update-2021-2027

1.15. We **advocate that the latest information available to the CAA is considered**, including using the latest STATFOR medium term forecast[10] published in October 2022 which benefits from evidenced traffic recovery profiles and developments of economic drivers.

1.16. **The latest STATFOR medium term forecast, which forecasts a return to traffic above 2019 levels being realised in 2024, seems to provide a reasonable outlook for traffic recovery** considering filed airline schedules for 2023, UK slot arrangements and the reduced levels of operational disruption in the aviation ecosystem[11], and also presents a reasonably consistent projection of traffic levels in comparison to the previous iteration published in October 2021 with limited acceleration of growth levels.

1.17. It is **essential that any adjustments to traffic forecasts are reflected in appropriately calibrated modification of building block allowances**, it is our priority that ex ante incentives are set that are consistent and appropriate for economic regulation, however, from a process perspective, airlines must be able to provide feedback on any changes that occur to the plan before NR23 is finalised.

1.18. We make our considerations relating to Oceanic forecasts as part of our comments on the Oceanic plan.

2. Service quality

2.1. **Appropriate performance incentives are a fundamental element of the price control** and ensure that the regulated company faces a commitment, and is **appropriately incentivised, to deliver service outcomes to the standard envisaged at the periodic review**.

2.2. **The connection between service performance with the analysis of opex and capex plans is fundamental,** ensuring that expenditure allowances are calibrated to the required service outcomes and that the outputs from investments are appropriately recognised.

2.3. **Safety remains our highest priority, which we are not willing to see compromised under any circumstances,** and we agree with NERL that it should also be at the heart of their business.

2.4. Whilst not explicitly covered in the CAA's proposals**, we support the continued measurement of safety against the current range of metrics** and NERL's proposal to continue to follow the European Risk Assessment Tool ("RAT") scheme complemented by other measures during NR23 against the targets set out in NERL's business plan. We expect NERL to at least maintain current safety standards and expectations as set out by the UK Safety & Airspace Regulation Group (SARG).

[10] https://www.eurocontrol.int/publication/eurocontrol-forecast-update-2022-2028
[11] https://www.oag.com/en/on-time-performance-airports-october

<u>Treatment of 2021 and 2022 incentives</u>

2.5. The CAA's decision on exceptional measures in response to the impact of covid-19[12] included the suspension of incentives for 2020, which was acknowledged by NERL which materially outperformed its service quality targets due to the significant downturn in traffic.

2.6. In its decision, the CAA set the expectation that it would take the same approach to 2021 incentives and potentially 2022, if traffic levels were to remain substantially below the baseline[13].

2.7. **We support the CAA's proposal to suspend 2021 incentives taking a consistent approach, due to the continued significant suppressed traffic levels** that materialised and were comparable to 2020 at around 40% of 2019 levels, with the relevant price condition term set to zero in 2023 charges.

2.8. **Due consideration needs to be given to determining if the same approach should be extended to 2022 incentives**, where there has been a significant increase in traffic following the restrictions enacted for the Omicron variant in the first half of the year and leading to overall traffic levels consistently materialising at around 87% of 2019 and critically, when considering the ex-ante approach to setting targets and incentives, **limited to around 80% of the RP3 forecasted traffic levels for 2022**[14].

<u>Environmental targets and incentives</u>

2.9. We **agree with the CAA that "NERL needs to contribute to UK government targets for net zero and aviation decarbonisation"**[15] and that the ability for airspace users to be able to plan and operate optimal flight paths through UK airspace is a critical contributor to reducing emissions, which NERL plays a critical role in enabling as well as delivering.

2.10. It is **fitting that environmental targets reflect the benefits generated from NERL's planned capex and opex alongside airspace modernisation changes**, the benefits from these investments should be rightly recognised with improved performance and, or reduced operating costs.

2.11. We recognise that **the 3Di metric represents the best available option at this stage and is highly preferable to the European KEA metric**; as such we support its continued use in NR23 subject to the continued tests for each of its four parameters on an annual basis, which appears to hold heightened relevance due to the failure of the tests in 2020 and 2021 and the instability in the model that this highlighted[16].

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[12] CAA CAP2279
[13] CAA CAP2394 p48
[14] CAA CAP1830 p23
[15] CAA CAP2394 p18
[16] CAA CAP2394 p52

2.12. We have raised our concerns with the 3Di metric in our response to NERL's Business Plan[17], and **welcome NERL's commitment to work with its stakeholders during NR23 to evolve the 3Di metric ahead of NR28**[18] to ensure it is a representative measure of optimal flight paths.

2.13. Based on pre-pandemic historic data, as part of its RP3 determination, the CAA allowed an adjustment to 3Di targets and actual scores to exclude a proxy 0.6 score points for training, positioning, surveillance, calibration flights and other non-revenue flights which NERL proposed total removal of in its NR23 business plan, excluding such flights from targets and actual 3Di scores.

2.14. The CAA raise the concern that **this generates a risk of inconsistency whilst still using the original 3Di model coefficients that included such flights and reducing the reliability of the modelling results**[19], which potentially reduces the validity of the 3Di metric further and seems to be a reasonable concern.

2.15. We advocate for a more systematic method for addressing these categories of flights impact on 3Di scores, it would be incongruous to remove these flights from targets and actual scores without conducting such an adjustment to the base coefficients; **rather than dismiss conducting such a review for the round of NR23 we would advocate that such an assessment is considered for incorporation into the CAA's Final Proposals and where this is not deemed feasible, we would support an expectation that this is completed ahead of NR28**

2.16. It seems **appropriate that the CAA has proposed to exclude NERL's proposal for traffic modulations to environmental targets** on the basis that they have "not seen clear evidence that traffic variations within reasonable bounds will have a direct effect on expected performance"[20] which we support based on the analysis undertaken by the CAA on pre-pandemic traffic, for such a scheme to be suitable it must be based on clear, robust evidence to avoid the risk of perverse outcomes from diluted incentives.

2.17. **It is our consistent view that targets and performance incentives should be calibrated to ensure that they are both achievable and incentivise performance improvement over time**, calibrated for current performance, reflect previous developments and investments as well as improvements derived from capital investments and should ultimately be linked to the operating expenditure required to deliver the service.

2.18. In setting the environmental targets for NR23 it appears that the CAA have adopted a reasonable start point considering the traffic level forecast in 2023 is lower than 2019 and that forecast in RP3, particularly in 2020 and 2021 where NERL faced

[17] https://www.caa.co.uk/media/euacxaxy/british-airways.pdf p27-29
[18] https://i.nats.aero/pubdocs/doc/appendix-f-environment/ p5
[19] CAA CAP2394 p53
[20] CAA CAP2394 p18

comparable 3Di targets[21]; this is further reinforced through the CAA's interrogation of NERL's 3Di reckoner used during the CCWG process and we fully support the assumption that "the starting point should reflect the benefits of capex up to the start of NR23"[22].

2.19. The application of 3Di benefits derived from the capex programme, outlined by NERL to be in the range of 2-3.3 score points, seems appropriate although **it is unclear as to what level the CAA has adopted from this range and what assessment lies behind such calculation.**

2.20. **Further consideration may be required towards the targets following the rephasing of the DP En Route** program during 2022 following the publication of NERL's business plan.

2.21. It would **appear appropriate that an underlying improvement factor was included in the targets**, reflecting improvements in working practices and the continued embedding of environmental considerations within NERL/ATCO, that incentivises environmental improvement beyond the benefits derived from the capex programme.

2.22. NERL's proposal to include a 0.29% per annum improvement seems acceptable as a minimum, based on the research conducted by Royal Netherlands Aerospace Centre, but appeared to lack the required level of ambition that is necessary for aviation to achieve its net zero target by 2050.

2.23. The proposed maintenance of the structure of the financial incentive similar to RP3 provides regulatory consistency and crucially allows sufficient time for incentives to play out following the changes made for RP3.

2.24. We support the expectation to review the 3Di metric and incentive ahead of NR28 to consider how the incentive can be strengthened and better targeted to reflect the considerable importance environmental concerns have for our business and customers.

2.25. Whilst 3Di scores can be influenced by factors outside of NERL's control, we believe it is the intent of the periodic review to recalibrate incentives across the whole price control and that where reopeners are used on specific areas in isolation this could risk an imbalance in the price control as many of the areas noted by NERL as having a potential impact on environmental performance would most likely have an influence on operating expenditure as well.

2.26. We are not convinced that reopeners are required at this time based on the CAA's assessment. The CAA's proposal for NERL to highlight any such one-off events and their impact on the 3Di score as part of NERL's quarterly performance reporting seems suitable.

[21] CAA CAP1830 p40, Table 3.3
[22] CAA CAP2394 p54, para 2.42

Capacity targets and incentives

2.27. We reiterate our position that it is critical for NERL to be in a position to meet capacity demands as the industry recovers, mirroring the priority passengers also place on punctuality.

2.28. Given the compressed timescales associated with this periodic review it does not seem unreasonable to maintain current capacity metrics, enabling the continued comparison of performance, through C1 and C2 metrics, to NERL's European counterparts

2.29. As with environmental targets, **it is critical that incentives are appropriately calibrated with building block allowances**, reflect the benefits derived from investments and airspace changes whilst also representing stretching but achievable goals to appropriately incentivise improved performance over time.

2.30. We **welcome targets that are more ambitious than those set in RP3 as well as NERL's business plan and agree with the CAA in its consideration that "NERL should be able to deliver better quality of service than set out in its business plan**, given historical performance prior to the pandemic"[23], observing that NERL earnt bonus payments on C2 performance in three years of RP2, significantly outperforming targets in two of those years, with 2015 exceeding the maximum bonus threshold; furthermore, we feel this is compounded when considering airspace changes and capex deliveries since these historic levels were achieved.

2.31. Whilst we welcome the more challenging capacity targets, **basing NERL's NR23 targets on average RP2 performance appears too simplistic**; NERL's significant outperformance of targets in a number of years in RP2, achieved against the backdrop of notably higher traffic levels than those forecast in setting the RP2 price control, combined with the drastic variance in NERL's performance determines that a deeper analysis is undertaken than that presented in the CAA's proposals to assess the core drivers behind NERL's capacity performance, reflection of investments and calibration across price control building blocks.

2.32. The CAA's approach to setting C1 targets, which forms a fundamental element in NERL's capacity incentives, appears to depart from the methodology used for RP3, where it is our understanding that the UK Network Operations Plan (NOP) was considered along with NERL's RP3 airspace and technology transition plan; in its proposals the CAA does not detail the calculation used for setting the C1 target beyond being an average of RP2 performance, from which C2 and C3 targets are calculated from.

2.33. The CAA detail the latest UK NOP in its proposals[24], which was published by Eurocontrol in July 2022 covering the period from 2022-2026 and sets out

[23] CAA CAP2394 para2.83

[24] CAA CAP2394b Appendix D Table D.3

dramatically lower levels of forecast delay in its base case to those proposed by the CAA, but it is not evident how the CAA have considered this forecast or NERL's NR23 transition plan in its calculations for C1 targets.

2.34. We would welcome further consideration of capacity targets by the CAA and **support engagement of stakeholders on this subject to further develop and refine proposals**.

Traffic Modulation and incentive adjustments

2.35. We support the CAA's findings on traffic modulation.

2.36. The reduction in the allowance for exemption days is welcomed following stakeholder concerns during NERL's CCWG process and business plan. However, it appears appropriate that **further assessment of the suitable level of exemption days is required,** especially given the lack of evidence provided by NERL to justify the allowance requested in the business plan.

2.37. **There should be a clear link between the number and extent of planned transitions within NERL's capex programme and the level of exemption day allowances**. Without being appropriately calibrated the allowance risks undermining incentives and leading to perverse outcomes.

2.38. Whilst we agree in principle with allowing appropriate time for incentives to play out and given their substantial review for RP3 it would seem reasonable to largely follow a continued structure; however, **given the fundamental reduction in the transition plan for NR23 to the one proposed for RP3, we consider that the CAA should review the balance of its incentives to reduce the weighting placed upon transitions applied to capacity incentives in the RP3 price control.**

3. Reconciliation review

3.1. **An ex-ante traffic risk sharing (TRS) scheme was in place for NERL and other European ANSP's in RP3**, following its precedent in RP2, under European charging rules and Eurocontrol Principles, which provided a consistent condition of protection to NERL for unexpected variations in traffic levels.

3.2. Following the onset of the covid-19 pandemic, the CAA committed to conducting a TRS reconciliation through the review of actual traffic levels and efficient actual costs for 2020 to 2022, which we support in that it should be assessed against information that NERL had available to it at the time of making its decisions and not be judged with the benefit of hindsight.

3.3. We note that NERL's costs and revenues, including forecasts for 2022, are £196m (10%) less than in the CMA determination over the reconciliation period[25], saving a forecast £229m of opex partially offset by an increase in regulatory return because of capitalising TRS revenue shortfalls, increasing costs by £24m, and a 5% reduction in non-regulatory revenues, generating £14m less revenue.

3.4. It is fitting that opex has been reviewed in detail given its material contribution to NERL's cost base. We would encourage the CAA to approach its future review of capex for the period with as much rigor as it has demonstrated towards opex assessments.

3.5. We believe NERL achieved a fairly reasonable range of actions but could have been more efficient in its efforts to reduce its costs in response to the various stages of the pandemic, with annual average staff costs 7% below 2019 levels saving £26m, and £85m (8%) below the CMA determination. The limited level of adjustments proposed by the CAA stands as an endorsement for the commendable efforts NERL made in a challenging period.

3.6. However, **we believe that NERL's approach to its voluntary redundancy scheme in 2020 could have reasonably been more efficient through either renegotiating its existing voluntary redundancy (VR) agreement or in bringing forward an exceptional VR scheme.** This would not seem unreasonable given the drastic situation and actions taken by other sectors within aviation, such as airlines, with multiple companies making significantly larger savings[26] and as part of their cost rationalisation enacting exceptional redundancy processes as well as making compulsory redundancies, estimated by Steer to be at much lower cost levels[27] than NERL achieved[28].

3.7. Steer's assessment that NERL could have achieved a **£26m cost saving if it had introduced an exceptional VR scheme with a 12-month payback seems reasonable and we advocate for its reflection in the CAA's assessment of NERL's efficient costs**.

3.8. It is unclear from Steer's assessment what the extent of the cost incurred through NERL's decision to top up furloughed employees' wages to 100% is, but **this action appears excessive with typical pay at airlines capped at either the government support level or topped up to 80% of standard pay**.

3.9. **The cost difference incurred by NERL's management decision to fully renumerate furloughed staff should not be considered as efficient** and should not be recovered from users.

[25] CAP2394 para 3.11
[26] Steer report Figure 2.19
[27] Steer report para 2.4.30
[28] Steer report para 2.4.31

3.10. The adjustments of NERL's capital program, as agreed with customers in 2020, is reported to have saved £231m, when including Oceanic capex, which was largely generated in 2020 and 2021[29]. We **recognise the difficulty in assessing the efficiency in these decisions at this point in time and that this assessment will be better positioned when the programs have been delivered, to which we expect a consultation and thorough review will be conducted ahead of NR28**.

3.11. Accounting for the appropriate adjustments to establish NERL's efficient costs sets the appropriate level of revenue to be accounted for under NERL's RP3 TRS mechanism. **This amount needs to be adjusted to account for the risk sharing element contained in NERL's licence**, accounting for NERL holding 100% of risk for traffic variations within a +/-2% dead band and 30% of risk for traffic variations above 2%, up to 10%.

3.12. This is consistent with NERL's RP3 licence and the modifications to it by the CAA. As a result, **the CAA needs to reflect users share of risk of the allowed revenue**, based on the assessment of NERL's efficient costs, to be recovered under NERL's TRS mechanism at 95.6%, with **NERL holding 4.4% of the risk**.

3.13. Accounting for the reduction to the efficient costs, to reflect for the appropriate adoption of Steer's cost saving assessment generated from the introduction of an exceptional VR program at £26m, the total efficient costs for recovery under the TRS are £664m. This should be further adjusted to reflect the disallowance for inefficient costs resulting from NERL's management decision to remunerate furloughed staff at 100%.

3.14. The application of the TRS risk sharing provision, with NERL holding 4.4% of risk for traffic variations of 10% or greater, results in **the appropriate covid TRS recoveries amount to be accounted for from users as being £635m, minus accounting for NERL's inefficient furlough wage costs**.

3.15. For clarity we have understood that **there is no tax allowance for the 2020-2022 TRS recoveries in NR23 (or in NR28) as this would have already been included in RP3**. We support this being excluded to avoid a double count in tax allowances for NERL. We would like this confirmed and we will require a review of the tax calculation.

3.16. In order to avoid a double count tax allowance related to the 2020-2022 TRS recoveries, we assume an adjustment has been made to the TRS figure added to the RAB.

3.17. For completeness we expect a full breakdown of the amount being to the RAB relating to the 2020-2022 TRS recoveries.

[29] CAP2394 Table 3.3

4. Operating Expenditure

4.1. The CAA must **only include efficient operating expenditure in the NR23 price control and ensure that NERL is appropriately incentivised to become more efficient over the course of the period**, promoting consumer benefits and productivity comparative to that expected in a competitive market environment, fulfilling the CAA's duties as set out in TA00.

4.2. In developing its final performance plan the CAA should be consistent in its consideration of the latest evidence available and its approach across the price control building blocks, which should be appropriately calibrated, to the challenges and uncertainties faced.

4.3. Overall, **we are largely supportive of the proposals put forward by the CAA but urge that the CAA ensures it has appropriately calibrated allowances across the price controls building blocks**, recognising the interdependencies between them and that benefits are appropriately recognised and accounted for.

Staff Costs

4.4. The CAA has identified three issues regarding staff costs that it has made proposals for to adjust NERL's business plan proposed levels, these areas are wage levels compared to benchmarks, ATCO productivity and graduate headcount.

4.5. We support the CAA's assessment, based on the evidence provided by Steer and NERA, in the context of the benchmarking of NERL's wage levels, that it is reasonable to assume slower wage growth than proposed by NERL and to utilise a wage growth rate reflective of suitable comparator roles.

4.6. We advocate that the CAA should adopt allowances that reflect wage levels in line with market benchmarks; **wages should represent the efficient level required to attract the required levels of talent without over-rewarding in excess of market rates**.

4.7. We believe the CAA **should set allowances reflective of the efficient levels required and those that would be required by an entity operating in a competitive environment**; it is for the regulated entity to decide upon its own actions and how it wishes to operate its business within the allowances established by the price control.

4.8. Steers assessment that a 1-1.5% improvement in ATCO productivity could be achieved by NERL does not seem unreasonable considering the historic improvements achieved by NERL, its European top-5 comparators, combined with the historic traffic growth and investments. However, we do caution that this is recognised by Steer as being based on an acknowledgement of "uncertainty of the timing of benefits of the capital programme of NR23" and considers "the expected level of traffic growth"[30], which we consider requires a level of revision based on the latest evidence available.

4.9. It appears that **the drivers contributing to ATCO productivity improvements need to be further understood through the provision and assessment of the latest evidence, for traffic forecasts, and additional evidence, relating to the capex programme, to enable the CAA to draw appropriate conclusions** and design suitable targets. It would seem reasonable to expect the thorough review of the capex programmes in particular to provide clarity and further evidence to support assessments in this regard.

4.10. Steer highlight that a number of areas where improvements could generate productivity gains, including; improvements in controller tools and other technology, increasing controller skills and experience, changes in airspace structures and by changes in the organisation and coordination of controller with the available technology.[31] It is our understanding that these are all areas set for developments in NR23 through what has been outlined in NERL's business plan, we therefore question NERL's assumption that these factors will not have a material positive impact on productivity.

4.11. We note that NERL "has confirmed that both airspace modernisation and incremental improvements to training and rostering could enable improved productivity during NR23, but that the benefits of this have instead been used to "better resilience, capacity and environment[al] performance"" and that the CAA judge "*this position, however, has not been clearly evidenced.*"[32]

4.12. **The apparent directing of benefits from developments in NR23 towards service quality as per NERL's plan highlights the requirement for the building blocks of the price control to be appropriately calibrated**. The CAA needs to be clear in ATCO productivity and service quality targets where the representation of benefits is directed and ensure this represents the most efficient outcome for customers and consumers.

4.13. We support NERL's objectives for its graduate programme but believe that the adjustment to the allowance for graduate headcount seems reasonable on the basis that NERL's retention rate appears too pessimistic or the that the number of roles required "significantly exceeds rates of attrition modelled within the business"[33].

4.14. The Institute of Student Employers identify an average graduate retention rate three years after the point of joining of 72% in 2022[34], far higher than the 50% level that Steer assessed has been assumed by NERL. Whilst their study shows average

[30] Steer report para 2.5.20
[31] Steer report p44
[32] CAP2394 p100
[33] CAP2394 p100
[34] https://ise.org.uk/page/graduates-more-likely-to-leave-jobs-than-at-any-other-point-pre-pandemic

retention rates have declined since 2011, the figures show levels have remained between 72% to 83% across the period and have been consistent between 71-74% since 2018. This appears consistent with Steers assumption of circa 75%[35]

Pension Costs

4.15. British Airways are generally supportive of the actions the CAA has proposed to make regarding Pension costs. Pension costs represent 20% of NERL's total operating costs; with NERL planning on them increasing through the course of NR23 by some 17%. **Ensuring that such a high proportion of the cost base is reasonable and efficient must be a major focus of the NR23 process.**

4.16. Although the DB scheme enjoys considerable protections, enshrined at the time of the public–private partnership, it is our view that NERL has failed to tackle the increasing costs of remaining elements of their pension scheme over the recent years. The generosity of the current DC scheme has long been pointed out by both airlines and CAA appointed consultants. Despite calls over many years now for NERL to introduce a new, less-generous, DC scheme for new starters from their customers NERL has failed to tackle this issue. **In the absence of competition and strong guidance from the regulator as to what would be considered reasonable and efficient in terms of pension costs it is easy for NERL to agree to pensions costs that are "higher than might be considered typical**"[36].

4.17. The current DC scheme creates an inflated obligation on NERL's customers to long-term funding of a scheme that costs approximately 16% of pensionable pay, **5 pts higher than the FTSE100 average** of 11%. Observations that this 16% is significantly less than the costs of the DB scheme seem to rather miss the point that CAA, economically regulating NERL, in the lieu of a competitive market, are meant to protect the consumers interests by ensuring only reasonable and efficient costs are considered in the final determined settlement. The situation could even be worse than this as Steer identified in their 2018 Pensions Study for Eurocontrol's Performance Review Commission that the average contribution across their sample was 9%.

4.18. British Airways strongly supports your statement that "there is evidence that the contribution rate for the DC scheme, in particular for new hires, could reasonably be reduced without putting NERL in a disadvantageous position relative to comparator organisations in terms of attracting staff"[37].

4.19. British Airways would question why the CAA has assumed a DC contribution rate for new joiners from 2024 to be 12% on average, when GAD say that **FTSE100 companies on average paying around 11% of pensionable pay** and Steer's study for Eurocontrol suggested the average across their industry sample was 9%.[38]

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[35] Steer report para 2.5.34
[36] Paragraph 4.69 of CAP2394
[37] Paragraph 4.74 of CAP2394
[38] Section 1.28 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

4.20. You note that your proposal to assume a new starter DC contribution rate of 12% will reduce pension costs in NR23 compared with NERL's business plan by approximately £1 million. The reduction in NR23 costs is not really the issue here though, it is a much more strategic and long-term issue. The CAA needs to grasp this nettle now to ensure, at a time when the issue is least painful for NERL to enact, that there is sufficient regulatory pressure for NERL to finally address the efficiency of their future pension costs for the next century or so. British Airways sees significantly more value in the long term to the creation of a fair (market rate) DC pension scheme for new starters than the £1m quoted as an NR23 saving. If 11% is a reasonable comparator then there is no reason the CAA should be guiding that 12% contributions for a new DC scheme would be acceptable.

4.21. Determining to allow for a NERL DC pension contribution of 11% of pensionable pay for new joiners, post 2024, will allow for a cost that is benchmarked as efficient from a FTSE100 benchmark. Whilst "only" 1pt lower than the 12% the CAA are initially proposing that 1pt cost must be seen in the context of a decades-long commitment by airspace users to fund an inefficient and unnecessary cost on one of NERL's largest costs.

4.22. British Airways welcomes the GAD review of NERL's pension costs. The report they have produced seems to be particularly useful in identifying some of the more the technical aspects of pensions provision.

4.23. GAD note that the Pension Cost Alternative costs (which are stated to be increasing to around 29% of pensionable pay in NR23 – and which we acknowledge is a saving of 37.2% versus the DB scheme in NR23) "is set at a level which appears to be sufficiently attractive to members".[39] They go on to say, "Whether the same level of take up would have been achieved if lower rates had been offered is uncertain.".[40]

4.24. The CAA have said "GAD did not identify any significant issues with the PCA scheme that NERL has in place and so we have adopted NERL's business plan forecasts."[41] But actually, **the review just seems to have skipped making any judgement on the efficiency of the PCA costs**, other in comparison to the DB scheme costs. Whilst noting that "The rate offered to new optants is subject to review in the future"[42] no commentary is offered on what an efficient / benchmarked PCA cost could be.

4.25. Clearly airspace users welcome the relative reduction of the pension costs that the PCA offers in comparison to the DB scheme (29% vs 66.2% in NR23). We also welcome the benefit offered to the scheme by the removal of the risk of a future deficit arising associated with the liabilities that would have occurred was it not for the Cash Equivalent Transfer Values (CETVs) for members who opted-out and subsequently choose to transfer their benefits out of the scheme entirely. But we

[39] Paragraph 1.13 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[40] Paragraph 1.14 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[41] CAP2394 paragraph 4.62
[42] CAP2394 Paragraph 1.15

can't help but wonder **how efficient the 29% cost is versus the market**. And lack of any commentary on this by the CAA or GAD could represent a lost opportunity.

4.26. British Airways welcomes GAD's expert technical analysis and their advice. GAD observe that "NERL's projected pension costs included within the Business Plan dated 7 February 2022 fall towards the upper bound of what GAD consider to be a reasonable and efficient range of pension costs for the NR23 price control period."[43] We are therefore **keen to ensure that CAA is taking note of the various opportunities and recommendations identified that would seek to reduce the cost borne by airspace users.**

4.27. We agree that **CAA should focus on engagement with NERL** ahead of the next actuarial valuation for the DB scheme (which is expected to take place after the end of 2023) in order **to provide guidance as to your expectations in relation to the assumptions made as part of that valuation**. We understand and accept that this focus would be expected to affect contribution rates and therefore pension costs from 2025 onwards.

4.28. GAD identifying that, based on NERL's business plan, that there is a risk that a **trapped surplus** could be expected to emerge in 2025, is useful. They further identify that, subject to legal clarification, there is the long-term likelihood that NERL cannot access any surplus until the pension scheme is wound up. GAD also say that they would expect the use to which any surplus is put to have regard to the best interests of consumers. GAD identify that they have indications that the pension scheme trustees might prioritise "de-risking the investment strategy"[44] "rather than passing savings onto consumers."

4.29. As a minimum we would encourage the CAA to ensure that NERL discuss with the Trustee's an "**overfunding mechanism**" / "**switch off" mechanism** to ensure that 'unnecessary' contributions are not paid and passed through to carriers and/or (as an alternative) to use an Escrow account, so that while contributions would continue, they would be earmarked for the scheme if a future valuation shows a deficit again, or if there is still a surplus it would be passed back to NATS for the benefit of airspace users.

4.30. Given the already very high costs of funding the DB scheme, alongside the added costs of recovering the COVID related costs, which are causing the unit rate to increase significantly, British Airways favours the CAA seeking to determine a settlement that reduces the likelihood of that occurrence and favours the reduction of these costs passed on to NERL's customers in the initial instance during NR23.

4.31. The lack of certainty as to how the trustees would manage any trapped surplus and the indications that they would be minded to prioritise de-risking the investment strategy would mean that any trapped surplus would not result in an assured reduced

[43] Paragraph 1.35 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[44] Paragraph 4.8 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

cost of airspace users at a time when the costs of operations are already significantly increasing.

4.32. The CAA say, of the DB scheme's current investment strategy, that "The CAA may want to engage with NERL to understand whether this is in the best interest of consumers."[45] On this subject GAD have said that "It will also be important to monitor the performance of the new investment mandates to ensure they are providing the intended risk-return and offering suitable value-for-money."[46] **British Airways would like to understand the CAA's intention here, in regard to how it would continue to oversee and monitor the appropriateness of the investment strategy and what powers it would have within NR23 to encourage the trustees to adopt any changes to that strategy that the CAA felt were in the interests of consumers**.

4.33. The GAD report says, in relation to the protections that are in place which restrict the extent to which the DB scheme's benefits and member contribution rates can be changed that "The CAA may like to take legal advice, if necessary, to understand the extent to which the NATS Section's provisions can be amended."[47] This suggestion does not seem to be addressed in CAP2394. **British Airways would like to understand the degree of certainty that the CAA already has that whatever flexibility that exists within the terms of the scheme** (specifically the Trust Deed and Rules, the 'Trust of a Promise' document and the 'Memorandum of Understanding') has been fully understood and that options the reduce the cost of provision of the schemes commensurate with that an efficient organisation would have taken has been properly explored.

4.34. British Airways would also like to understand how the CAA plans to engage with NERL on issues relating to the **pensionable pay cap** (which are currently limited to a maximum of CPI + 0.25% a year up to January 2024) and also the indexation on benefits (where benefits accrued after 31 October 2013 are increased in line with CPI in payment as opposed to RPI) to ensure that any future agreements on pensionable pay after 2024, and the secondary impacts on pension cost, are reasonable and provide value to the airspace users. How comfortable are the CAA with the assumptions NERL made in the in their Business Plan for the pensionable pay projections from 2024?

4.35. Following changes in the UK's rules relating to "contracting out", and as noted by GAD, NERL "decided not to implement changes to those minority of active members without the protection."[48] This decision by NERL effectively saddled airspace users with an increase in the costs of pension provision which could have been avoided. This appears to be another case of NERL, under the CAA's watch, failing to grasp the importance of ensuring costs in this area of their spend is of fundamental importance to airspace users.

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[45] CAP2394 paragraph 4.65
[46] Paragraph 1.22 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[47] Paragraph 3.3 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[48] Paragraph 3.17 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

4.36. British Airways agrees with GAD's suggestion that "The CAA could **consider the merits of approaches used by other regulators to incentivise their regulated companies to manage their pension schemes more effectively**."[49] Again this issue does not seem to make it into CAP2394 and British Airways would like to understand the CAA's plans here.

4.37. GAD identifies that the **administration costs** of the pension scheme represent approximately 2% of the NATS section pension costs (as included in the Business Plan). Whilst previous stewardship tests have sought to justify these costs, which are "**higher than average** according to data published by The Pensions Regulator",[50] the underlying historic justification of the level of administrative charges seem to have fallen away. We are left with a situation whereby the pension scheme administration costs, on a per member basis, at NERL are c.£360, which compares unfavourably to the average cost incurred by schemes with 1,000-4,999 members of £145 and even less favourably to the £70 cost for schemes with 5,000+ members. NERL has approximately 6,000 members.

4.38. It appears that **the CAA should conduct a review of the latest stewardship report with a view to contenting itself that the administration cost**, which are a minimum of more than double that of comparator schemes could be considered efficient. The CAA should also provide guidance as to your expectations in relation to reasonable administration costs to NERL.

4.39. GAD identifies the most significant assumption underlying the pension costs in NERL's business plan as being those relating to the **discount rate**. They say that "Considering the NATS Section's investment strategy, strong employers covenant and relative immaturity, we would expect the that the funding strategy would be broadly between the 70th and 95th percentile of Defined Benefit pensions schemes". The current discount rate is broadly 75th percentile. British Airways is therefore supportive of the CAA identifying that you "consider that there may be opportunities for future DB pension scheme valuations to include assumptions about the discount rate closer to the GAD mid bound, reflecting assumptions which are more consistent with the 85th percentile of DB pension schemes."

4.40. GAD also identify that there is scope for consideration of a **slowing down in the assumptions associated with the transition to the long-term funding strategy**. They suggest that "CAA may also wish to consider whether further guidance on their expectations from NERL in further negotiations on appropriate time-horizons for transitioning to the long-term funding target would be useful. This may aid NERL at future valuations (such as the valuation due no later than 31 December 2023)."[51]

4.41. As stated previously British Airways acknowledges and welcomes that the CAA's initial proposals on pensions costs remove a singifcant cost for airspace users when

[49] Paragraph 4.33 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[50] Paragraph 7.1 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc
[51] Paragraph 6.23 of the GAD report to the CAA "Analysis of pension costs for NATS (En Route) plc

compared to NERL's business plan. We are however very mindful of how determinations in this area quite often end up obliigating customers to fund costs for decades. Opportnities identified and presenting at this time to reduce the costs of pension provision need to be **fully and carefully considered**. **It is not good enough to be satisifed with reducing costs from the already very high cost levels.** The final NR23 determination must ensure that only reasonable and efficent funding of the pension scheme is allowed.

Non-staff opex

4.42. We welcome and endorse the CAA proposal to determine NERL's non-staff opex at 1% below that in NERL's business plan based on your assessment of:

- the removal of CAA fees in NR23
- expected opex efficiencies
- removal of UTM[52] development costs (based on user pays principal)
- not allowing real increases in the DB pension management costs

4.43. We would also like to acknowledge the work that NERL did during COVID pandemic to reduce their non-staff operating costs, such that their performance in this aspect was toward the upper quartile of ANSPs in Europe. This enabled Steer to determine that they did "not find any grounds for suggesting amendments to these values".[53]

4.44. British Airways remains concerned about the significant increase in Asset Management costs that result primarily from the extended period of "dual running" of both legacy and new systems that NERL proposes in their latest plan for the deployment and implementation of DP En Route & Voice for upper airspace while at the same time legacy systems remain in operation for lower airspace.

4.45. The Steer NR23 price control report[54] correctly identifies that we "do not fully understand the strategy leading to significantly higher sustainment operating and capital costs and delay in the delivery of the capital programme and benefits for DP En-route/Common Platform"[55]

4.46. We are therefore interested to understand more about the alterative "stepwise" deployment plan developed by Steer, or any other challenge to the NERL plan that could reduce costs and deliver benefits earlier.

4.47. The CAA have said "we have not been able to adopt Steer's "stepwise" legacy escape profile as part of our assumptions, and therefore have not included the £20 million of asset management savings identified by Steer in our forecasts." [56] Th rationale for this decision has not been explained and given that it is the largest

[52] Unmanned aircraft system traffic management
[53] Paragraph 3.4.27 Steer NR23 price control review report – Steer reference 24135901
[54] Steer Reference 24135901
[55] Paragraph 3.5.10
[56] 4.84 of CAP2394

potential saving in non-staff opex identified by Steer it is worthy of a more detailed explanation.

4.48. We therefore welcome the suggestion in paragraph 4.85 of CAP2394 for a review of the possibilities to improve the efficiency of the implementation schedule for DP En Route ahead of your final Performance Plan decision.

4.49. It would be our preference that you would seek to assure yourselves as to the efficiency of the deployment and implementation of DP En Route at this time, as opposed to ex-post. The statement that you "will also carry out a full review of the DP En Route programme once it is complete, to establish whether NERL delivered it in an efficient way"[57], is also welcome. This statement should have the effect, at this time, of encouraging NERL to further assure themselves that their current plan is as efficient as it can be.

5. Capital Expenditure

5.1. In NR23 we are faced with a significantly reduced capex programme compared to the one proposed for RP3 following actions taken during 2020-2021, with NERL's ability to implement change constrained as a result of its redundancy programme and the reprofiling of the capex plan in NERL's iSIP21 process.

5.2. These actions have resulted **in a reduced capacity for the implementation of major system transitions, which are critically required to enable the realisation of the UK's airspace modernisation strategy** and is a continual fundamental priority for British Airways in unlocking the multitude of significant benefits associated to this programme; in this context we support every effort in ensuring that NERL is enabled to deliver its airspace modernisation requirements, within an efficient cost envelope, to the associated timeframes and that NERL does not form a constraint to the UK's airspace modernisation.

5.3. NERL's business plan set out a capital plan with **reasonable objectives for investment in NR23** that is principally led by the sustainment of existing systems complemented by airspace modernisation and DSESAR requirements; however, we **have questioned if the significant increases in sustainment costs and the balance between sustainment and modernisation are efficient.**

5.4. As we commented in our response to NERL's business plan; "Sustainment is clearly a critical leg of the capital investment programme, since maintaining resilience and redundancy of existing assets allows NERL to deliver its high-quality service to the highest safety standards; nevertheless, the logic underpinning this level of costs needs to be carefully scrutinised to ensure it is both appropriate and realistic"[58].

[57] Paragraph 4.85 of CAP2394
[58] BA's Business Plan Response p42

5.5. We note **Steer's recommendation for the adoption of their "stepwise" scenario, which appears to present a number of benefits compared to NERL's plan**, and believe that this in combination with the CAA's information requirements and the proposal for a thorough review of NERL's capex plans and NERL's own investigation into its ability to increase its delivery capabilities, **forms a strong basis to require engagement of stakeholders and appropriate consultation to address ahead of the CAA determining its final performance plan.**

5.6. It is **concerning that the CAA have found that "NERL has not provided sufficient detail around the business cases associated with the programmes and projects included in its plan"**[59] and that "at an overall plan level, it is difficult for us, or stakeholders, to understand the degree of efficiency of the spend proposed, or the benefits that consumers can expect to derive for the plan (other than at a very high level)."[60]

5.7. Whilst we are supportive of NERL's proposed 2+5 capital planning approach, there is the requirement on NERL to be able to provide an appropriate level of detail including anticipated benefits, impact to opex and service performance as well as cost estimates to enable the appropriate assessment by customers and the CAA.

5.8. **The requirement for, and the replanning of, the DP En Route programme is concerning**; whilst NERL's active engagement of stakeholders was commendable in terms of speed of engagement and willing, **the quality of information shared did not enable appropriate considerations of the options presented**; the delay to the programme heightens concerns about NERL's ability to deliver its plans as well as the implications such a drastic revision of costs and delivery timescales implies to other programmes; as a result, **we welcome the CAA's requirements on NERL to thoroughly review its plan.**

5.9. The information requested by the CAA to enable the appropriate assessment of capex plans should form the basis of information requirements placed upon NERL for its future customer engagements, and that the quality of information provided by NERL should be appropriately considered within the capital engagement incentive to incentivise improved behaviours by the regulated company and address repeated issues in this regard that were also raised in the development of the RP3 price control.

5.10. We are disappointed that the CAA has not consulted on or proposed any developments to the regulatory mechanisms to enhance their compatibility with NERL's 2+5 capital planning approach; given how the capital plan is likely to evolve over time, as evidenced in RP2, it would appear appropriate for the CAA to consider developments to better support NERL's planning approach.

[59] CAP2394 para4.115
[60] CAP2394 para 4.116

6. Financial framework

RAB

6.1. British Airways supports the position that NERL is compensated for efficient financing and efficient investment of Capex in order to maintain safe and resilient activities.

6.2. British Airways continues to advocate the introduction of CPI indexation of the RAB for NR23, rather than continuing to use outdated indexation calculations using RPI that have been withdrawn as a national statistic

Regulatory Depreciation

6.3. We are supportive of your proposal to retain the RP3 approach you took to estimate regulatory depreciation as set out in paragraph 5.26 of CAP2394, noting that this approach was supported by the CMA at the time of their review.

Inflation

6.4. On page 9 of their report[61] CEPA have presented their views on inflation and included details of alternative forecasts in Table 2.1. We do understand that you propose to update inflation forecasts for the final performance plan and that forecasts have been changing rapidly recently. We urge the CAA to use the most relevant and up to date forecast available to you at the time you are making your final decision.

6.5. British Airways supports moving to a CPI indexation of the RAB. We would prefer this move was made for NR23 but understand that the CAA will look at this again in NR28. It will be our clear view that that RPI indexation cannot continue into NR28. As such we understand the need to maintain the current RPI-CPI wedge mechanism (from RP3 into NR23) that seeks to allow for the fact that the RAB is indexed to RPI and charges to CPI.

Tax

6.6. We support your proposal to set out an explicit tax allowance or revenue building block in your calculations of NERL's price control revenue rather than applying an uplift to Vanilla WACC which is more difficult to reconcile. We note that you say that this change in approach to calculating tax allowance has no disadvantage to that used in RP3. That assurance, and knowledge that this change follows in the footsteps of determinations made by regulators, such as Ofwat and Ofgem, in other industries provides comfort that this approach should work.

6.7. British Airways is supportive of the measures proposed to increase the transparency of tax liabilities (versus RP3) and welcome your efforts to ensure that only efficient

[61] CEPA: NERL Cost of Capital – Response to the CAA's Initial Proposals

tax based on known inputs such as the corporation tax rates and efficient use of capital allowances and notional deductions such as interest payments are accounted for.

6.8. For clarity we have understood that there is no tax allowance for the 2020-2022 TRS recoveries in NR23 (or in NR28) as this would have already been included in RP3. We support this being excluded to avoid a double count in tax allowances for NERL. We would like this confirmed and we will require a review of the tax calculation.

WACC

6.9. We have appointed CEPA to conduct analysis of the WACC included in the CAA's Initial Proposals, which is attached as Appendix A, and point the CAA to consideration of CEPA's report for representations of our views regarding WACC.

6.10. We draw particular attention to the following observations:

- The **approach to estimating the WACC is broadly consistent with H7**, particularly for its market wide parameters, and the overall range is comparable to the CMA's RP3 vanilla WACC range of 2.41-3.74%. **As a result, several long-standing concerns previously shared with the CAA continue to apply.**
- The **CAA's IPs are based on a cut-off date for data of 31st March 2022**. This is **unhelpful given the material relevance of data available** between the cut-off date and the October 2022 date of publication.
- We **advocate that the CAA takes account of the latest available evidence in developing its final proposals** and ensures that calculations are made accurately and critically without bias particularly where volatility in the underlying data may make conclusions more sensitive to timing assumptions than would ordinarily be the case.
- **UK inflation has been exceptionally high and is forecast to remain so at least in the short term**. We recommend using the most up to date data possible and having reference to market-based inflation estimates, which currently tend to give lower real yields.
- **Benchmark market rates have been volatile and particular care needs to be taken that timing assumptions**, such as choice of data windows or rolling average periods, do not inadvertently result in an over- or under-estimate of the cost of capital.
- The CAA **should take care to ensure that its assumptions about the profile of inflation over time** in setting an allowance for the cost of debt are consistent with its assumptions about the profile of NERL's debt balance over time.
- We **consider that the CAA is wrong to adopt the CMA RP3 asset beta as the pre-pandemic asset beta for NR23**. The estimate is impacted (both directly and indirectly) by the onset of the covid pandemic. A value closer to the CAA's own estimate of the RP3 asset beta would be more appropriate.
- **The range that the CAA has presented for the Total Market Return (TMR) appears unnecessarily wide and is upwardly biased**.
- We **continue to disagree with the CAA's estimation of a pandemic uplift**, both as applied to NERL for NR23 and as applied to Heathrow Airport for H7.

6.11. We submit our **full considerations on the CAA's provision for NERL's WACC in our consultant's report, attached in Appendix A, published by CEPA**.

6.12. We would **welcome further engagement with the CAA on these issues** to help ensure they consider all relevant evidence and arguments.

7. Charges and financeability

7.1. The CAA holds consideration of NERL's financeability within its secondary duties and we support the assertion that NERL should retain access to financial markets on reasonable terms, as required within NERL's licence for it to ensure that it maintains an investment grade issuer credit rating[62]. This should benefit customers and consumers through reduced financing costs and be reflected in NERL's WACC calculation.

7.2. The building block allowances are a critical component in establishing NERL's determined costs and we believe that it is appropriate for elements within these building blocks are adjusted by the CAA in its development of its final performance plan. We also advocate for the adoption of the latest information available to the CAA, including the update of traffic forecasts. As such we expect these adjustments to be accounted for in updated determined costs in the final performance plan.

7.3. We note under the CAA's proposal that NERL's average determined unit cost (DUC), based on Total Service Units (TSU), for NR23, before NERL's 2020-2022 TRS recovery debtor is accounted for, is £48.40 in real 2020 CPI prices, decreasing from £52.40 in 2023 to £44.50 in 2027[63].

7.4. The UKATS DUC includes the costs generated by the MET Office, Department for Transport, Eurocontrol and the CAA. The average DUC for NR23, in real 2020 CPI prices, is £56.31 and starts at £60.64 in 2023 before decreasing each year of the period to £52.23 in 2027.

7.5. In addition to recovering its determined costs, there are significant TRS revenues to be recovered from 2020 to 2022. We consider that it is **reasonable to recover these revenues over 10 years, split evenly between NR23 and NR28**. Reducing the repayment period or increasing the weighting of recoveries in NR23 would put further considerable upward pressures on affordability as airlines continue to recover from the impacts of covid-19 and consumers face a level of uncertainty in the economic outlook.

7.6. We **agree that there is a strong argument for smoothing the impact of the covid TRS recoveries to support affordability in the early years of the price control**, without which DUC's would peak to around £66 (2020 CPI real prices) in 2023 and

[62] NERL's licence, Condition 5, para 23
[63] CAP2394 Table 6.7

2024, based on the CAA's current proposed inputs. It **appears reasonable to adopt a flat profile of charges** in NR23 in real terms.

7.7. The application of a flat profiling the CAA forecast NERL's unit rates over NR23 will be £54.38 per TSU[64] (CPI-real 2020 prices), with the forecast rate subject to potential changes in period as a result of traffic variations, incentives and pass-through mechanisms.

7.8. We note that the CAA will apply its Initial Proposals to set the level of charges in 2023, with the provision for adjustment, which will have effect from 2024, to account for differences to its Final Performance Plan.

8. Regulatory incentives and mechanisms

Uncertainty mechanisms

8.1. The proposed traffic risk sharing mechanism based on the default mechanism included in the EU charging rules for RP3 would provide a largely consistent approach from previous price controls and should be appropriately reflected in the CAA's estimations of NERL's WACC.

8.2. **The design of the TRS should be tailored to NERL's particular business**, with dead bands only if they are logical based upon the operating leverage in the business and in particular avoiding incentive issues where sharing rates change dramatically.

8.3. We agree with NERL that it is "in users' interests to seek to avoid sharp increases in prices following major shocks to the aviation sector, while recognising that a clear and secure regulatory policy on the ultimate recovery of allowed revenues is vital to underpin the efficient long-term financing of the ANSPs"[65] and **welcome the concept of smoothing the costs of any significant traffic downturn but believe further refinement for the consideration could be appropriate**. The adjustment of the recovery period for traffic variances that are greater than +/-10% could be further considered.

8.4. In order **to assist the affordability of charges in the event of significant traffic downturns, we propose that consideration is given to allowing up to a maximum airline liability per year of 5.6%,** reflecting the maximum amount airlines are liable for recovery of within a single year when traffic variation falls up to the +/-10% threshold under the CAA's proposals.

8.5. Consideration should be afforded to the **extension for the recoveries to be made to a maximum of a 10-year recovery period**, following precedent established in the CAA's determination of NERL's 2020-2022 TRS recoveries.

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[64] CAP2394 Table 6.10

[65] https://i.nats.aero/pubdocs/doc/appendix-i-determined-costs-ducs-and-prices/ p10

8.6. Where a traffic variation would not allow for the full recovery of the TRS debtor within the 10 years at the maximum rate of 5.6% per annum, it could be appropriate for the recovery to be spread evenly over a 10-year recovery period. However, **it is likely to be appropriate in any traffic downturn of this magnitude for the CAA to review the TRS mechanism to establish the best course of action pertinent to the specific situation**.

8.7. We calculate that it would require a single year traffic variation of over 60% from forecast, or 2 consecutive years with traffic variations over 35% respectively, to trigger a requirement for the 5.6% per annum limit to be revised. Details of indicative calculations are provided in Appendix B.

8.8. **Any adjustments must be tailored to the issue that is trying to be solved, and this is particularly important where inflation of the RAB resulting from the TRS debtor is so material**; depreciation of amounts placed onto the RAB should be logically established, and if significant deviation is required from that logic, such debtors might instead be recovered through alternative mechanisms.

8.9. It is **important to consider the proposed separate treatment and recovery of the TRS debtor from the main RAB raises the question of whether a different cost of capital should instead be applied to the TRS debtor**; the logic should be based upon consistent use of the RAB or separate depreciation of the debtor at a different cost of capital.

8.10. We would **welcome consultation and engagement to explore the implications of such adjustments to find an optimal solution** for customers, consumers and in ensuring efficient finance costs of NERL.

8.11. **We do not support the introduction of a TRS mechanism to Oceanic traffic**. A significant portion of the Oceanic service is already protected from traffic risk through NERL's contractual arrangements with Aireon. There would need to be a clear and proportionately substantial benefit to consumers to justify the additional complexity.

8.12. We support the CAA's assessment that **there is no requirement for the inclusion of adjustments for asymmetric risks**. The analysis of STATFOR's forecast accuracy appears to draw logical conclusions that the application of a shock factor would not be appropriate for NERL.

8.13. We note the assessment that NERL faces a lower level of risk relative to HAL and could be reasonably considered reflective of NERL's level of risk compared to all airport comparators, due to its reduced exposure to commercial revenue risks and as such should be reflected appropriately in the calculation of NERL's WACC.

<u>Airspace modernisation</u>

8.14. **We fully support the appropriate provision to enable the efficient delivery of airspace modernisation** including the allowances and governance proposals set out by the CAA in its Initial Proposals.

New Users

8.15. There is a high degree of uncertainty towards the services and infrastructure required by new users during NR23 and further into the future in NR28. **We support the CAA's proposals that address concerns regarding the existing user pays principle** that had arisen as a result of NERL's proposed approach.

8.16. The CAA's approach appears to address financial implications of providing services to new users during NR23 but is unclear how the CAA proposes to account for the impacts to the service provision for existing users. The innovation of airspace and introduction of new users' needs to be approached in harmony of existing users' requirements and the provisions made in the price control.

Capex incentives and governance

8.17. We agree with the CAA that "High-quality engagement between NERL and its customers is an important part of our approach to the economic regulation of NERL. It is key to ensuring that NERL's investment in capital programmes is both economical and efficient, and furthers the interests of customers and consumers"[66]

8.18. Following the CMA determination, the CAA introduced a capex engagement incentive for which Egis, acting as independent reviewer, has assessed NERL's capex engagement in its iSIP21 and iSIP22. Egis' conclusion that NERL had built on improvements and taken account of feedback it had been provided, while noting areas for improvement existed, seems an acceptable assessment, reflective of our engagement with NERL and their proactive endeavours to improve behaviours in this regard.

8.19. Whilst the capex engagement incentive is relatively new (having been introduced in 2021), it would seem that both the CAA and independent reviewer have learned a significant amount about the practical operation of the incentive in that time. Trusting in the practical experience that you have gained, British Airways therefore supports the adjustments that you have proposed making to refine and improve the incentive mechanism, as well as the 2+5 planning approach adopted by NERL, that heighten the requirement for quality engagement, appropriate for NR23.

8.20. We support the clarification to scoring criteria to ensure that the traceability of information is improved.

8.21. The core area we advocate improvement of in NERL's capex engagement is regarding the quality of information provided by NERL to customers to enable the appropriate assessment of costs and benefits of options and their implications to

[66] CAP2394 para 7.83

other elements of the capex plan and wider business with specific reference to opex. We would seek information akin to that requested by the CAA for its determination of capex allowances for this price control.

8.22. It is unclear to us as to the extent of appropriateness of capturing "the timeliness of mitigating/corrective actions" within the capex engagement incentive. Our interpretation of the statement is that this would be targeting capture of the timeliness of capex actions taken by NERL, which does not feel appropriate under this incentive and would better be reflected within the ex-post capital efficiency incentive. If the intention of the statement is to ensure the capex engagement incentive captures the timeliness of NERL's engagement of customers in the instance of mitigating/corrective actions being required, then we are supportive of this being included in the incentive.

8.23. We believe the licence modification proposed in Condition 10 clarifies this but would appreciate confirmation of aligned intentions from the CAA.

9. London approach

9.1. We are supportive of your proposal to **retain a stable regulatory framework that is a relatively simple, straightforward and proportionate approach** to regulating these charges.

9.2. The CAA should **reassess the appropriateness of the traffic forecast for London Approach that was based on STATFOR October 2021** in light of STATFOR's October 2022 forecast.

9.3. British Airways supports keeping the cost allocation unchanged and support your proposal that "the cost allocation for London Approach in RP3 should be retained for NR23".[67]

9.4. We advocate for regulatory consistency, following the RP3 precedent with aligned TRS mechanism between En Route and London Approach, and **for the adoption of arrangements from En Route to be applied for London Approach in regard to both the NR23 TRS mechanism and 2020-2022 TRS debtor recoveries**.

9.5. We highlight again our **concerns at the appropriateness of the TRS debtor assuming a 100% pass-through to users and believe this should reflect the risk share arrangement within NERL's RP3 licence**, with NERL holding portions of risk within the 2% and 2-10% bandings.

9.6. We support your proposal to **retain the requirement on NERL to report on its London Approach delay performance** and do not currently seek to make a case for the introduction of financial incentives on London Approach delay.

[67] Paragraph 8.18 CAP2394a

10. Oceanic

10.1. We continue to **support the CAA's desire to maintain a proportionate approach to the regulatory framework relating to Oceanic operations**; keeping it stable, simple and straightforward, whilst also mirroring the method for calculating NERL's en route price control.

<u>Oceanic Traffic Forecasts</u>

10.2. As STATFOR does not produce a dedicated Oceanic forecast and the publication timeframe unclear for the next iteration of ICAO's North Atlantic Economic, Financial and Forecast Group ("NAT EFFG"), there is a clear issue with deriving an appropriate forecast that is similarly independent to that available for En-Route and London Approach services.

10.3. We note that the North Atlantic has experienced strong recovery of traffic over the course of 2022 with Europe-North Atlantic traffic +2% vs 2019 same week[68].

10.4. As highlighted during the NATS CCWG process and subsequent NR23 Business Plan consultation[69], Oceanic forecasts clearly need further scrutiny to address the discrepancies identified by NERL in the STATFOR data sets generated from the STATFOR October 2021 forecast, basing the price control on what has already been acknowledged as incorrect information would not be appropriate.

10.5. We welcomed NERL's transparency in identifying the discrepancies in the underlying STATFOR data sets and its commitment to work with Eurocontrol to revisit the flow assumptions for the STATFOR short term update in June 2022 but note that the Oceanic forecast used in the CAA's Initial Proposals has not been updated from that used in NERL's BP.

10.6. Following the publication of the latest STATFOR medium term forecast in October 2022[70], encompassing the NR23 price control period, it would appear reasonable that the latest data sets to feed NERL's Oceanic forecast model are assessed in line with other independent forecasts that may exist and are transparently shared with customers

10.7. It would also appear appropriate, given the significant disparity between the RP3 and NR23 forecast, that the Tango forecast generated by NERL is also scrutinised and forecast drivers assessed

[68] https://www.eurocontrol.int/sites/default/files/2022-11/eurocontrol-comprehensive-air-traffic-assessment-20221125.pdf p19
[69] https://www.caa.co.uk/media/euacxaxy/british-airways.pdf
[70] https://www.eurocontrol.int/publication/eurocontrol-forecast-update-2022-2028

10.8. It is crucial that in the absence of an independent Oceanic set of forecasts, the CAA adopts a process that allows the airlines to engage in the assumptions used and transparently review the forecast model.

10.9. The current NR23 forecasts, especially for the Tango routes, are significantly adrift from RP3 forecasts.

TANGO route forecast	20	20	20	20	20	20	20	20
RP3 (000s)	45	46	47	49	53			
NR23 (000s)				24	26	29	30	31

10.10. And forecasts for the north Atlantic don't get back to the volumes forecast for 2020 until 2027 when demand for transatlantic flights has recovered strongly post pandemic.

North Atlantic forecast	20	20	20	20	20	20	20	20
RP3 (000s)	49	49	50	51	52			
NR23 (000s)				47	46	46	47	48

<u>Oceanic Plan</u>

10.11. Applying similar efficiency targets and cost reductions in line with those applied in your initial proposal for the wider NATS UKATS cost is sensible. We have commented on those more general assumptions, such as opex and pensions, elsewhere .in this response.

10.12. The reduced volume forecast for the Tango routes results in a significantly increased ADS-B data cost in NR23 vs RP3. We welcome the confirmation that "charge for Tango flights, calculated by sharing the fixed cost of providing data in the Tango region across the annual forecast of flights in that region."[71] However (accepting the necessarily very high level presentation of the costs in your table) when multiplying the "Traffic Forecast: Tango" and the "ADS-B data costs: Tango" from Table 9.8 of CAP2394a it would seem that the "fixed cost" might not be all that fixed.

	2023	2024	2025	2026	2027
Traffic forecast: Tango (000s)	24	26	29	30	31
ADS-B data costs: Tango	£6.3	£5.7	£4.9	£4.7	£4.5
Calculated Tango route ADS-B costs (£m)	£1.512	£1.482	£1.421	£1.41	£1.395
As presented in Table 9.8 of CAP2394a – ADS-B data costs Tango (£m)	£0.2	£0.1	£0.1	£0.1	£0.1

10.13. The north Atlantic data charge has previously been presented as being fixed on a per flight basis, which are then passed on to airspace users with no additional margin. It would seem that NERL has been able to secure some reductions in price here, which is welcome, with the Unprofiled ADS-B data charge per NA crossing from by about £1.50 a crossing from 2025 (from c.£31.50 to c.£30.00)

10.14. British Airways supports your initial proposal not to include a TRS mechanism on the Oceanic service.

[71] Paragraph 9.31 of CAP2394a

10.15. It remains appropriate for the stakeholder to conduct a review of the cost and benefit of the SB ADS-B service on the north Atlantic. When introduced the data service increased oceanic crossing costs by some 2/3rds but ANSPs touted savings way in excess of that extra cost. Unable to validate the savings ANSPs said would flow, airlines were generally somewhat sceptical and reluctant to incur the significant increase in their cost base for Atlantic crossings.

10.16. The impact of the global pandemic on traffic has delayed our ability to meaningfully review on any consistent basis the impact of the introduction of SB ADS-B on the costs incurred by airlines crossing the Atlantic (which could be measured in terms of things like reduced fuel burn/$CO2$ emissions as well as reduced flying time and reduced delay). The need to review this issue remains, but, like the CAA, British Airways believes this review can take place after NR23.

10.17. When the benefits of SB ADS-B have been lauded by NATS previously they have suggested significant before would come from truncation of, and eventual dismantling of the Organised Track System (OTS). This would seem to be an important measure of value delivery (attributable to SB ADS-B) alongside the improved percentage performance of flights being provided with the requested clearance (or operationally equivalent profile) and flights being cleared for variable speeds.

11. Affordability appendix

11.1. We appreciate the analysis you have undertaken and provided here and your consideration of the issue. Despite your assertion that "NERL's charges form a small proportion of airlines costs and of the ultimate ticket prices experienced by passengers"[72] the total costs of overflying and air traffic management do form a significant cost for airlines. It is important to us that the CAA act to ensure that only efficiently incurred costs are passed through to airspace users and that the service provided by NERL stands compare to comparator ANSPs. You efforts and proposals to smooth the impacts of unrecovered pandemic related costs are spread equally over a 10 year period, so as to avoid a short term price spike are welcome.

12. Draft licence modifications appendix

12.1. We understand and support the indicated changes required to be made to Condition 6 of the Licence to incorporate the required reporting for costs associated with regulating new users.

12.2. We support an enhanced requirement in Condition 10 for 'timeliness' to be included in the measure of the quality of customer engagement. Reporting to customers, at a point in time that it is still relevant, i.e. when actions could still be taken to change matters; is vital to quality engagement.

[72] Paragraph F37 of Appendix F to CAP 2394

12.3. Proposed changes to Condition 10a (Airspace Modernisation) are supported.

12.4. The deletion of Condition 18 (Payment of fees) is supported.

12.5. Changes proposed to Condition 20 (Price Control Conditions) are required and are supported.

12.6. In relation to the draft changes proposed to Condition 21 (Control of Eurocontrol Service Charges) we have commented elsewhere in this response as to our thoughts on issues like the TRS mechanism and service quality performance metrics that have figures drafted into the proposed licence terms. We can't endorse the proposed forecast of Total Service Units values.

12.7. As with Condition 21, for Condition 21a (Control of London Approach Charges) we have commented elsewhere in the document on issues relating to the change proposed on issues like the TRS. We can't endorse the proposed London Approach traffic forecasts as per the draft licence.

12.8. We would welcome clarification of how the ADS-B charges mentioned in the changes proposed to Condition 22 (Oceanic Charges) are calculated. We can't endorse the proposed Oceanic traffic forecasts as per the draft licence.

12.9. Condition 24 (Information to be provided to the CAA in connection with the Charge Control Conditions) should make clear that any charges levied on new users will include a share of all applicable costs associated with services provided to the new user, and not just a share of newly incurred incremental costs.

We welcome further engagement as the CAA refines its proposals prior to publishing its Final Performance Plan.

Yours sincerely,

Rory Lillington
Economic Regulation Executive
Networks & Alliances
British Airways Plc

By the CEPA economics matters

Appendix A to British Airways response to CAA CAP 2394

NERL Cost of Capital – Response to the CAA's Initial Proposals

IAG

12 December 2022

FINAL REPORT

Contents

EXECUTIVE SUMMARY

CEPA has been appointed by IAG to provide advice on cost of capital issues. In this note, we provide our analysis in response to the CAA's NERL NR23 (NATS En Route Licence) Initial Proposals (IPs).

The CAA's proposed RPI-real vanilla post-tax WACC range is 2.04%-3.59%, with the CAA signalling that it sees no reason to depart from the midpoint of 2.81% in selecting a point estimate. This midpoint is 73bps below the estimate provided by NERL in its business plan of 3.54%. The overall range is broadly comparable to the CMA's RP3 vanilla WACC range of 2.41-3.74%.

The CAA's IPs are based on a cut-off date for data of 31st March 2022. This is unhelpful given the material relevance of data available between the cut-off date and the date of publication (October 2022). The CAA has not given stakeholders a meaningful opportunity to understand and comment on how it would interpret this data. The Ofgem ED2 Final Proposals, published on 30 November 2022, included a data cut-off of 31 October 2022 for its analysis in the energy sector. Given the impact of the covid pandemic and its importance in the CAA's preferred methodology, it is especially important that stakeholders are presented with the CAA's current thinking. The only time we will see the CAA's thinking on data movements since March 2022 will be at Final Proposals, when we have no ability to challenge any interpretations that we disagree with.

Asset beta

The largest area of challenge to the CAA's IPs relate to the asset beta, where we consider that the CAA has overestimated both the pre-pandemic beta and the pandemic uplift.

- We consider that the CAA is wrong to assume that the CMA's RP3 decision reflects a suitable estimate of the pre-pandemic asset beta. This assumption is inconsistent with the CAA's (and its advisers') own analysis. The result of this is a pre-pandemic asset beta that is too high.
- We consider that the CAA is wrong to use a re-weighting approach to assessing the pandemic impact. This flawed methodology yields results that over-estimate the pandemic impact on NERL's enduring asset beta.
- The CAA and Flint have not demonstrated why 26-months should be considered the appropriate assumption for the covid pandemic duration. This has the impact of over-estimating the pandemic impact effect.
- The CAA has selected a range that includes all data points it considers relevant. However, in using this approach to construct a range it fails to acknowledge that it has presented more data in support of a number in the lower part of its range.
- We also highlight issues with comparator selection, relative risk and empirical estimation which means that the CAA has overestimated the suitable asset beta for NERL in NR23.

We recommend applying a smaller uplift to a lower assessment of NERL's pre-pandemic beta to give an asset beta estimate no higher than 0.52.

Inflation

Recent outturn and forecast inflation data has been exceptionally volatile and unstable. This will mean that the CAA's Final Proposals are likely to be exceptionally sensitive to choices between sources, forecast periods and averaging approaches. Whilst we consider the CAA's structure approach to inflation reasonable, in light of this volatility it should be particularly mindful that the details of its approach do not inadvertently over- or under-estimate the resulting cost of capital.

We continue to view market-based estimates for inflation as more consistent with the CAA's estimation of other parameters. The value of high frequency market-based data is even greater in the presence of heightened volatility and unstable forecasts: the change in recent OBR forecasts highlights the risk of using infrequent independent forecasts. The OBR's November 2022 forecasts will be around six months out of date at the time of FPs; a period of time over which its forecast recently moved by over 500 bps.

Based on current data, alternative forecasts would support an inflation assumption between around 50 bps (based on incorporating alternative independent forecasts) and 150 bps (based on RPI swaps) higher than the CAA has assumed in its IPs.

Cost of debt

As for inflation, market data on the cost of debt is highly volatile. The CAA should take particular care in reaching Final Proposals that its proposed bespoke calculation of NERL's cost of debt does not inadvertently result in an over- or under-estimate of the cost of capital. The de-risking effect of this approach (which we do not disagree with in principle) should be adequately reflected in the allowed cost of equity.

The CAA should also be mindful of its bespoke approach in applying an inflation forecast to deflate nominal yields to a real allowance. NERL's stock of debt is projected to fall over time, given that it has a £450m amortising bond. The average rate on its debt will reflect this[1]. As a result, forecast inflation in the first year of NR23 (when the stock of debt is relatively high) will be more relevant than in later years (as the stock of debt falls). This arises as a function of the bespoke approach to estimating the allowed nominal cost of debt and expectations of varying annual inflation.

There may be a risk that using a simple average of forward-looking inflation is not suitable for the purpose of deflating nominal debt yields. The CAA should consider alternative approaches to summarising inflation forecasts, which we estimate would reduce the allowed real cost of debt by around 5 bps under the CAA's current methodology. This would be consistent with their approach to estimating nominal costs of embedded debt.

In addition, acknowledging a wider evidence base in forming its inflation forecast would, as we set out above, reduce the allowed real cost of debt by around 50 to 150 bps.

Other issues

We continue to recommend that the CAA tests the sensitivity of its decision to alternative reasonable choices for notional gearing, bearing in mind that there is evidence from comparators both above and below its assumption of 30%. Should it select a notional gearing other than that which minimises the calculated WACC, this decision should be accompanied by a clear supporting rationale.

[1] See CAA Initial Proposals, Appendix C, paragraph C151 and paragraph C158.

1. INTRODUCTION TO CEPA ANALYSIS

The remainder of this note presents CEPA's analysis of and supporting evidence for: Inflation (Section 2); Market rates (Section 3); Total Market Return (Section 4); Asset beta (Section 5); and Gearing (Section 6). For completeness we briefly summarise other issues in Section 7.

2. INFLATION

We consider that the CAA's structured approach to inflation is reasonable, but with highly volatile inflation, the CAA must be mindful that its approach makes use of all available evidence.

In Initial Proposals, the CAA's main scenario applies a data cut-off of 31st March 2022, and its alternative scenario includes data until end of August. The CAA acknowledges that the March cut-off does not capture recent developments such as increases in inflation and bond yields over the summer and autumn of 2022, but has opted for this choice because of "significant uncertainty" in the evolving situation.

The CAA's current approach for deflating the cost of debt is to use a long-term approximation of RPI which does not fully reflect the short-term volatility and instability of forecasts. We present in Table 2.1 below inflation forecasts from different bodies, relative to the CAA's own forecasts. Independent forecasts for 2023 have risen by over 500 bps, and forecasts for 2024 are as much as 900 bps lower than for 2023. For the NR23 IPs, the CAA has assumed a 3.16% average RPI over the five-year period. This assumption is misaligned with the balance of current evidence on inflationary trends: both the BoE and the IMF produce higher CPI estimates than the OBR, which suggest an RPI estimate at least 50 bps higher. The CAA should be clear in explaining the time horizon that this long-term measure represents, and whether it is reflective of the overall tenor of NERL's debt.

We present inflation forecasts below from different bodies, relative to the CAA's own forecasts. For the NR23 IPs, the CAA has assumed a 3.16% average RPI over the five-year period.

Table 2.1: Inflation Forecasts from CAA IPs compared to recent data form BoE, IMF and OBR

	2023	2024	2025	2026	2027	Average
CAA IP figures[2]						
NERL Forecast - RPI	3.16%	2.96%	3.11%	3.17%	3.20%	**3.12%**
NERL Forecast - CPI	2.13%	1.85%	1.84%	1.87%	1.93%	**1.92%**
CAA IPs - RPI	5.51%	2.34%	2.52%	2.71%	2.71%	**3.16%**
CAA IPs - CPI	4.04%	1.54%	1.88%	2.00%	2.00%	**2.29%**
More recent figures						
OBR forecast (Nov 2022)- RPI[3]	10.70%	1.50%	-0.40%	1.00%	2.60%	**3.08%**
OBR forecast (Nov 2022)- CPI[4]	7.40%	0.60%	-0.80%	0.20%	1.70%	**1.82%**
BoE (Nov 2022)- CPI[5]	5.25%	1.50%	0.00%	-	-	**2.25%**
IMF (Oct 2022) - CPI[6]	9.00%	3.70%	1.80%	2.00%	2.00%	**3.70%**

Source: CAA (2022) NR23 provisional numbers; recent figures are from BoE, IMF and OBR.

[2] CAA (2022) NR23 Initial Proposals – Main report.

[3] OBR (2022) Economic and Fiscal Outlook – November 2022. Available online at https://obr.uk/efo/economic-and-fiscal-outlook-november-2022/

[4] Ibid.

[5] Bank of England (2022) Monetary Policy Report – November.

[6] IMF (2022) GBR Country Data webpage. Available online at https://www.imf.org/en/Countries/GBR#countrydata

In our response to the H7 Final Proposals (and earlier consultations), we expressed a view that market-based measures of inflation were preferrable and available given the CAA's continued use of a real RPI cost of capital. These values are updated daily (rather than monthly, quarterly or bi-annually) and reflect the behaviour of investors, rather than the predictions of forecasters. If we look at current implied inflation over a five-year period using break-even inflation, implied average RPI inflation is still currently over 4.0% (at end-November 2022), having been close to 5% during the summer months and earlier in 2022.

Figure 2.1: UK five-year RPI breakeven inflation

Source: Bloomberg

A further source of market evidence on inflation would be RPI swaps. At our cut-off date of 30 November 2022, a five-year RPI swap was at 4.74%. If the CAA use the OBR November 2022 estimate of 3.08%, or their current estimate of 3.16%, they need to explain what is driving the difference and why they place sole weight on the lower number (hence a higher real cost of debt). The CAA use index-linked gilts to estimate the risk-free rate, so cannot consider that breakeven inflation (a measure inferred from index-linked and nominal gilts) is inappropriate.

We consider that the CAA should make use of market-based estimates for inflation in its FPs – both for consistency with its estimation of other parameters and to mitigate against the instability of infrequent forecasts. In forming its overall assessment, the CAA should consider alternative independent forecasts alongside market data. The CAA should also be clear in explaining the time horizon that this long-term measure represents, and whether it is reflective of the overall tenor of NERL's debt.

Use of a market-based inflation estimate could reduce the real cost of debt by up to around 150 bps, based on the above evidence[7]. The CAA's alternative scenario in Table C.7 uses a 4.11% average RPI assumption over NR23 – this itself implies that the inflation assumption used should be higher with more recent evidence.

3. MARKET RATES

As noted on the section on inflation, we agree with the CAA that there has been a period of short-term volatility. This applies to both government debt and corporate debt. A key challenge facing the CAA is determining whether

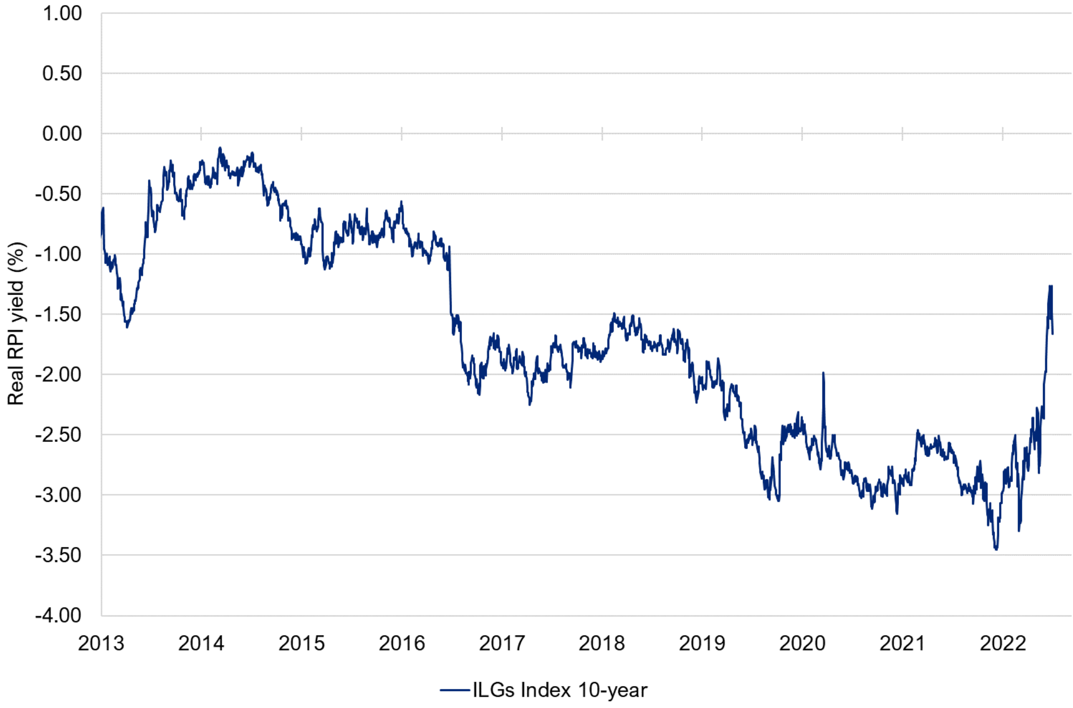
[7] The CAA deflate the entirety of the assumed embedded cost of debt and the new cost of debt by expected RPI inflation over NR23.

the change in yields reflects a move to a new level of interest rates, or simply a transitory spike in yields caused by an external shock with the Ukraine conflict and subsequent impacts on energy prices. It is problematic that the CAA has not addressed more recent data and given an indication of its current thinking.

3.1. Context: Recent market volatility

We present evidence on the evolutions on yields on the government and corporate bond yields in Figure 3.1 and Figure 3.2 respectively.

Figure 3.1: Yields on UK Index-Linked Gilts (ILGs)



Source: CEPA analysis of Bloomberg

We have presented ILG yields over a ten-year horizon. Current yields are similar to yields last witnessed in early 2019, but remain lower than the majority of the 2013-16 period.

Figure 3.2: Nominal yields on iBoxx GBP Non-financial corporates 10yr+ BBB index

Source: CEPA analysis of Markit iBoxx

When we look at nominal yields on debt, yields increased by c.350bps since the end of March 2022. However, these have since fallen c.175bps since that peak. The figures shown are also nominal yields, therefore we need to be consistent in deflating those into a real RPI equivalent value.

We discuss the risk-free rate and cost of debt in more detail in the sub-sections below.

3.2. Risk-free rate

The CAA's general approach is to estimate the risk free rate (RfR) based on the yield on index-linked gilts (ILGs) with a maturity of 10 years, using a one-month trailing averaging period consistent with H7 Final Proposals. It then makes an adjustment to the ILG-based rate, placing some weight on a convenience yield uplift (+37 bps) estimated from the difference between the yield on iBoxx AAA 10-15 non-gilts index (as in CMA PR19) and nominal gilts of a similar maturity. They do not make use of a forward adjustment suggested by NERL.

Currently, the CAA's cut-off date of 31st March means the risk-free estimate is lower than it would be if more recent data was included. There should be no obstacle to using up to date data for FPs, with a cut-off date much closer to the date of publication than was the case for IPs.

For H7, and NR23, the CAA has switched to using a 1-month averaging period (with a similar change on the cost of new debt) from a 6-month averaging period. We note that this will change the level of the risk-free rate (and cost of new debt) to be closer to current conditions, but as an approach it will lead to larger fluctuations in regulatory allowances than a smoothed longer profile. As shown in Figure 3.1 and Figure 3.2, the choice of cut-off date will have a material impact where annual updates do not take place through indexation mechanisms.

We consider that a convenience yield uplift is not a required feature of the CAA's judgement, noting that whilst the CMA included such an adjustment in its PR19 redetermination it has also endorsed the exclusion of such an adjustment in its GD&T2 appeal decision.

3.3. Cost of Debt

For the cost of embedded debt, the CAA have a discrepancy between the values reported in the main section of the NR23 report, and what is reported in appendix C. We have continued in this section discussing the Appendix C values.[8]

Table 3.1: Inconsistent reporting of Cost of Embedded debt

	Main Report	Appendix C
Nominal Cost of Embedded Debt	2.11%	2.24%
Inflation (RPI) average	3.16%	3.16%
RPI real Cost of Embedded Debt	-1.02%	-0.89%

Source: CAA (2022) NR23 Main Report and Appendix C.

The CAA estimate a nominal embedded debt of 2.24%, and a RPI-real cost of embedded debt -0.89%, deflated by the forecast level of RPI over the NR23 period of 3.16%.

In contrast to H7 (and other regulatory regimes concerning larger and more stable asset bases) the allowance for the cost of debt is based on a bespoke approach. In principle we do not take issue with this approach, as long as the costs are compared to appropriate benchmarks and demonstrably efficient. The approach the CAA have used for NERL is outlined below:

- The CAA has used separate benchmarks for each of NERL's bonds, based on corporate bond indices of similar credit rating and duration, and taken account of the amortising balance.
  - £450 mill 10 year amortising bond (maturing March 2031) - estimated using weighted average of the yield on the iBoxx £- denominated A-rated 5 to 7 year index and the corresponding 7-10 year index as at April 2021 ➔ estimated cost of 1.34%.
  - £300 million 12.5 year bullet bond (maturing Sept 2033) – estimated using the yield on the iBoxx £-denominated A-rated 10 to 15 year index as at April 2021 ➔ 1.88%
  - A forthcoming bond to replace 2-year bridge facility – estimated based on the yield on the iBoxx £-denominated A-rated 10 to 15 year index as at 31 March 2022 ➔ 2.88%.
- Weighting these costs by the value of principal outstanding in each year of NR23 implies a nominal cost of embedded debt of 2.24%.

As discussed already, there is volatility in the market rate of debt and recent forecasts of inflation have been unstable. Given that the CAA deducts its assumption for forecast RPI inflation from its assessment of the nominal cost of debt, our analysis in Section 2 suggests that the real cost of debt allowance has been overstated by between 50 and 150 bps.

Volatility in the market rate of debt also means that the timing risk of debt renewal is heightened. In setting a bespoke allowance, the CAA has insulated NERL from a high degree of risk – and one which has resulted in significant under-performance of the allowed cost of debt in other regulated sectors where regulated businesses have raised debt infrequently. As equity investors bear the ultimate risk of mismatches and under-performance, this must be adequately reflected in NERL's allowed return on equity and specifically the equity beta.

The proposed bespoke calculation of the cost of debt also interacts with the challenge of interpreting and applying volatile inflation data. The declining balance of debt reflected in the bespoke calculation may mean that a conventional simple average of forward-looking inflation is not suitable for the purpose of deflating nominal debt yields. NERL expects to have more debt outstanding in the first year of NR23 than in the last. As a result, the first

[8] There is more discussion and detail surrounding the Appendix C values in the CAA's IPs. Our analysis would not be significantly changed were we to refer to the values used in the main report.

year of expected inflation will have a proportionately greater impact on weighted average inflation over the whole life of its debt. We estimate that this weighting would reduce the real cost of debt by around 5bps using the CAA's current March 2022 OBR forecasts. This figure would be expected to increase with the new profile of November 2022 OBR forecasts.

4. TOTAL MARKET RETURN (TMR)

The CAA's approach to estimating TMR is to weight both CED-CPI and CED-RPI series to deflate historical equity market returns. The CAA also include an adjustment (similar to that done by the CMA) to account for 2010 change in formula.

We agree with the CAA that the TMR is unlikely to be perfectly stable and fully independent of the risk-free rate and inflation – at least not indefinitely. While the CAA has referenced uncertainty in arriving at their point estimate, we would consider that it would have been preferrable to reflect this directly in the calculation of the TMR and Market Risk Premium (MRP).

We note that the TMR range adopted by the CAA is particularly wide at 5.20-6.50%. When we consider the range of regulatory determinations for a suitable point estimate, we see that recent regulatory decisions have been bunched around 5.40-5.85%. This indicates that the CAA's mid-point is likely to sit at the top end of a plausible range for the TMR, rather than reflect a balanced mid-point estimate.

Table 4.1: Total Market Return value used in other regulatory final decisions in UK (RPI real)

		Final decisions:	**TMR (RPI real)**
2019	August	CAA - NERL RP3	5.40%
	December	Ofwat - PR19	5.47%
2020	December	Ofgem- GD2 & T2	5.64%
2021	March	CMA - PR19	5.85%
	March	Ofcom - WFTMR Openreach	5.70%
	March	Ofcom - WFTMR Other Telecoms	5.70%
	March	UR - PC21	5.85%
	June	CAA - H7	5.85%
2022	November	Ofgem – ED2[9]	5.50%
Mean			**5.66%**
Range			**5.40%-5.85%**

Source: UKRN (2022) Cost of Capital Report; Ofgem (2022) ED2 Final Determinations

We do not present new analysis on the TMR, but in retaining its H7 Final Proposals approach, the CAA has not resolved the issues we highlighted in previous reports.

5. ASSET BETA

On the asset beta, we discuss three points that build on discussions on H7:

- the suitability of CMA's asset beta as a pre-pandemic asset beta;
- further discussion on the pandemic impact 're-weighting' approach; and

[9] 6.50% CPIH real is estimated at 5.50% RPI real, using an assumed differential of 100bps. Where other values were deflated using CPIH, we have included the RPI equivalents reported in the UKRN report.

- estimating a suitable range for the pandemic impact on the asset beta.

We then highlight a number of points raised as part of previous NR23 and H7 consultations that continue to apply, including the following items:

- comparator selection;
- relative risk effects; and
- relative index choice.

5.1. Suitability of CMA's asset beta as a pre-pandemic asset beta

We consider that the CAA is wrong to assume that the CMA's RP3 decision reflects a suitable estimate of the pre-pandemic asset beta. This assumption is inconsistent with the CAA's (and its advisers') own analysis. The result of this is seen in a pre-pandemic asset beta that is too high.

The CMA, in their RP3 decision, consider data before 28th February 2020.[10] The CMA set out an unlevered beta (i.e. with zero debt beta) of 0.50-0.60.[11] The CAA's own Final Proposals had adopted an unlevered asset beta of 0.40 (equivalent to a 0.46 asset beta with a 0.10 debt beta at 60% gearing). The CMA did not update their Final Report from their Draft Report, given complications arising from Covid. The decision was intended as a settlement to hold for a shorter number of years "*until such time as the impact on the industry can be better understood and a more comprehensive reworking of the regulatory settlement can be undertaken.*[12]"

We disagree with the assessment that the CMA's unlevered asset beta range of 0.50-0.60 should be adopted as the suitable pre-pandemic estimate of beta. We can see in the CAA's analysis that evidence considered was covid impacted. Figure 5.1 below presents a copy of the CMA's Figure 13.3 from its RP3 Final Report, showing the asset beta for ENAV, the sole listed ANSP listed.[13] The two-year daily and weekly asset beta estimates have moved from around 0.40 up to 0.47 and 0.56 respectively by end-February 2020.

The CMA then used an asset beta range for ENAV of 0.45-0.55 to inform its judgement for NERL (Table 13-10). This corresponds best with the pandemic-impacted end-February 2020 data points: the upper end of 0.55 is never observed prior to that in the daily data and only on two specific occasions in the weekly data; and the lower end excludes prolonged periods in both the daily and weekly data with observed betas in the 0.40-0.45 range.

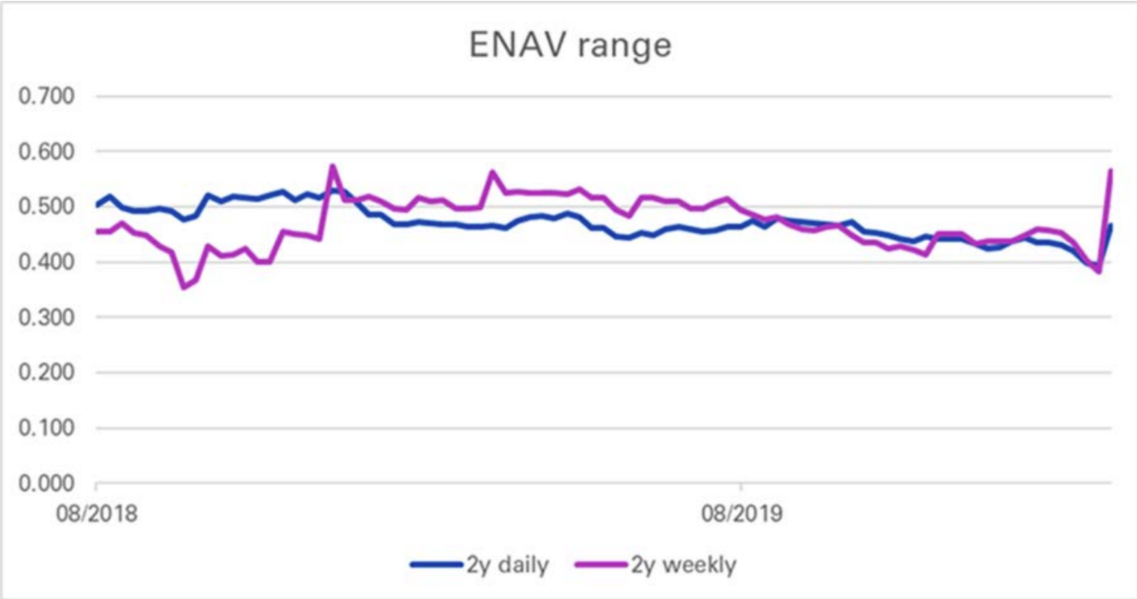
[10] CMA (2022) NATS (En Route) Plc/CAA Regulatory Appeal. Final Report. Available online at https://www.gov.uk/cma-cases/nats-en-route-limited-nerl-price-determination

[11] 0.52 to 0.62 with a debt beta of 0.05

[12] CMA (2022) ibid.

[13] As ENAV was only listed in July 2016, only data from 2018 can be used to estimate the asset betas for a 2-year estimation window.

Figure 5.1: ENAV asset beta



Source: CMA (2020) RP3 NATS (En Route) Plc /CAA Regulatory Appeal Final Report – Figure 13.3.

It is clear that these spot betas were covid impacted, noting that quarantines in Italy began in February 2020. The financial impacts on the asset beta would likely be geographically influenced. The CAA and Flint also agree with this statement, as their pre-covid period ends on 31st January, one-month earlier than the CMA analysis cut-off. However, the analysis uses a "pre-pandemic" estimate that includes pandemic-affected data to end-February 2020, but then estimate an uplift based on beta estimates up to end-January. This is inconsistent.

Flint's report acknowledges that there is a risk of double counting of February data, but suggests that "an earlier cut-off date would not materially change the CMA's range". We have not seen evidence to support this statement and given that the CMA made an 'in the round' assessment on beta, this evidence will not exist.

Flint also state that the methodological choices might have led us to estimate a lower baseline beta for NERL had they carried out the analysis bottom-up, but that they consider the CMA's pre-covid asset beta estimate to be most appropriate, due to regulatory consistency. We again disagree that this supports regulatory consistency as, the CAA's own view of asset beta at RP3 was lower than that of the CMA. The CAA is required to make their best assessment of the evidence available to it.

5.2. CAA/ Flint's 'reweighting' approach

We consider that the CAA is wrong to use a re-weighting approach to assessing the pandemic impact[14]. This flawed methodology yields results that over-estimate the pandemic impact on NERL's enduring asset beta.

In the H7 response, we set out that the CAA/Flint's approach to estimating the pandemic uplift (a 'reweighting approach') creates an inappropriate upwards bias around a shock event. The use of a singular covid window and pooling observations across periods which they consider to have different coefficients is econometrically unsound and, as a result of the disproportionate influence of outliers, does not achieve the stated aim in terms of the relative balance of pre-pandemic and pandemic data. We presented the below example to highlight an issue.

[14] We have also referred to this as a 'pooled' approach in our consultation responses to the H7 price control.

Box 1: Example of issues with reweighting approach – from CEPA H7 FP response

We assume that we are two years after a pandemic, with one year of pandemic data and one year of non-pandemic data for a single comparator, Aena, with an indicative pandemic frequency of 1-in-10 years. We are seeking to understand the impact of a third year of data, where this is a non-pandemic year.

Using the CAA/ Flint 're-weighting' approach the asset beta we can see the impact of this in Table A.3.

Table: Comparing results with additions of non-pandemic data

Data	Data sample	CAA/ Flint asset beta	Difference vs non-pandemic	Duration of impact	Pandemic frequency	Total impact on beta
Non-pandemic	1yr non-pandemic	0.561	-	-	-	-
1yr data	1yr pandemic	0.979	0.417	1yr	10%	0.042
2yrs data	1yr pandemic 1yr non-pandemic	0.946	0.384	2yrs	10%	0.077
3yrs data	1yr pandemic 2yrs non-pandemic	0.906	0.344	3yrs	10%	0.103

Source: CEPA analysis, Bloomberg

The addition of non-pandemic data under the CAA/ Flint 're-weighting' approach inadvertently lengthens the period in which there is an observable pandemic impact, with perverse outcomes. We can see by moving from two years of data to three years of data that the pandemic impact increases. This is despite the addition of a further year of non-pandemic data.

The effects are very significant; moving from a total beta impact of +0.042 with one year of pandemic data to +0.103 with one year of pandemic data and two years of non-pandemic data. The effect increases as more non-pandemic years are added to the sample, based on this re-weighting approach.

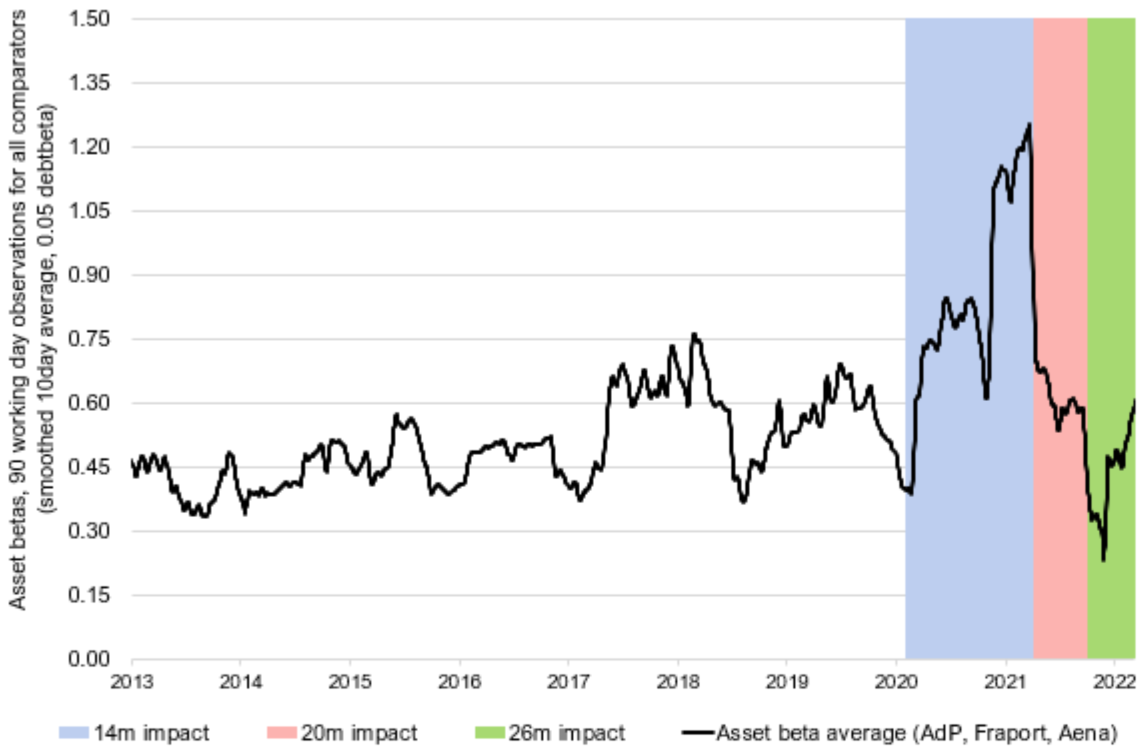
The above example was intended to illustrate how the approach is very sensitive to the inclusion of more data and the assumed covid duration. We can see from Flint's own analysis that this problem has arisen with respect to assessing when the covid impact should be assumed to have ended. We discuss this below.

The CAA and Flint have not demonstrated why 26-months should be considered the appropriate assumption for the covid pandemic duration. This has the impact of over-estimating the pandemic impact effect.

We appreciate that the Flint report shows sensitivities of the inclusion of different time periods, namely Table 10 of their report. If the same overall re-weighting approach is maintained (which we note above that we have issues with), more evidence is needed to support why a 26-month assumed duration of the pandemic should be assumed to be the correct one.

We present in Figure 5.2 below short-term betas for listed comparators, highlighting the results for the periods considered in Flint's three sensitivities. We show an average of the three airports the CAA and Flint place most weight upon – AdP, Fraport and Aena.

Figure 5.2: Short-term betas and choice of covid impacted data[15]



Source: CEPA analysis, Bloomberg

The CAA's preferred approach assumes that there is a 26-month impact on financial markets[16]. Therefore the CAA and Flint consider that the blue, pink and green shaded areas should be considered covid-impacted. The CAA and Flint have not established why they consider that to be the case.

If we consider that the pink and green areas are either not covid impacted or treated explicitly as non-covid periods, the asset beta falls. Under the CAA and Flint's preferred methodology, this can reduce the asset beta impact by 0.01-0.02, prior to the application of their sensitivities. Flint notes that the sensitivity of this assumption has a more significant impact for ENAV.

While 0.01-0.02 on the asset beta does not sound large, at 60% notional gearing this could increase the cost of equity by 40bps[17], using the CAA's current ERP and TMR assumptions.

The impact is also expected to be larger than this, given that the CAA and Flint range for the uplift is scaled up by 1.5x the assumed pandemic duration in the upper bound. Based on Flint's findings, if we assumed a 14-month pandemic impact, the upper end of the CAA's pandemic uplift range could fall to 0.07 from 0.11[18].

We have previously noted that the upper bound assumptions on duration and frequency do not pass the 'sniff test'. Assuming a 3.5yr impact that begins once every 20yrs, suggests that 17.5% of all observations will be covid impacted. This is close to one-full year in every five-year price control. If this did happen to be the case in future,

[15] As in previous studies, we do not consider that NERL's (or Heathrow's) asset beta should be based on short-term betas. However, we consider that this analysis provides context and helps to identify trends in periods shorter than the two-year estimation window typically as a benchmark in beta analysis.

[16] We reiterate that the impact should be thought of as the period where the beta is elevated due to the dominance of a pandemic in investor's behaviour, not any health or social impacts associated with a pandemic.

[17] Or c.20bps at 30% notional gearing.

[18] This is inferred from Flint's analysis and reference to their 20-month sensitivity as an approximation of a 21-month period (14-months multiplied by 1.5x).

using the covid pandemic to estimate the magnitude of such an event would be unnecessary, as it would represent much more of a regular occurrence.

5.3. Estimating a range for the pandemic impact

The CAA has selected a range that includes all data points it considers relevant. However, in using this approach to construct a range it fails to acknowledge that there is more data to support a number towards the lower part of its range.

The CAA and Flint's central estimate of the pandemic impact is 0.03-0.08. This would give a mid-point of 0.055.

When the CAA and Flint run sensitivities to develop a lower bound and upper bound, this changes the range to 0.02-0.11. The mid-point increases to 0.065. It is unclear why the CAA's estimate should change from these sensitivities in practice.

In addition, the Flint report presents sensitivities (as discussed above with respect to Table 10) that indicate that that base range could be lower, potentially more akin to 0.02-0.06. The Flint report provides more evidence for a number towards the lower end of the 0.03-0.08 range, with very limited support for a number above this. Yet the CAA use a 0.065 uplift through use of the mid-point more generally. We consider that this does not reflect the available evidence.

5.4. Relevant arguments on asset beta from previous consultations (NR23 & H7)

Comparator selection

The CAA use three comparator airports (Fraport, Aena and ADP), with the addition of ENAV. We agree with the addition of ENAV as a comparator air traffic control company, However, more generally we have previously supported the consideration of a broader set of comparator airports and we maintain that view. The empirical asset betas in the CAA's comparator set sit towards the top end of the range for a broader comparator set.

Relative risk effects

We continue to consider that NERL's systematic risk exposure is lower than indicated by the CAA in its IPs. The risk insulation measures to NERL, including Traffic Risk Sharing, inflation indexation and material protection on recovering embedded debt costs are seen in the NR23 Initial Proposals.

Relative index choice

We have previously mentioned that we consider there is merit to considering results using both domestic indices and continental indices as part of beta analysis. Together with different gearing choices, this can have a material impact on beta.

5.5. Summary

We have previously provided an estimate, based on pre-pandemic evidence, of 0.43-0.50 for NERL's beta.[19] This was based on a relatively short period of evidence for ENAV's asset beta, long-run evidence for airports and airport groups, and an assessment of NERL's relative risk. The main change between our judgement in November 2018 and the beginning of the covid-19 pandemic in early 2020 was the emergence of additional data on ENAV's asset beta. This data was consistent with our judgement (see Figure 5.1 above) and so we have not changed our assessment.

[19] CEPA (November 2018) 'Cost of capital for NATS (En Route) plc'.

We have also carried out analysis and engaged in extensive discussion of a suitable adjustment to pre-pandemic beta data in the context of the H7 price control. We have previously concluded that an addition of up to 0.02 may be warranted to give an estimate of Heathrow Airport's long-term, forward-looking asset beta.[20] It is not clear to us that there is a robust basis for reaching a different view for NERL.

On that basis, we conclude that NERL's asset beta for NR23 should be no higher than 0.52.

6. GEARING

We have no objections in principle to the CAA's 30% notional gearing assumption. The CAA should continue to be conscious of the impacts its choice of gearing can have on the cost of capital, and should have regard to comparator evidence that could support either a higher or lower assumption.

CAA use a long-run value, placing weight on observed gearing from listed comparators, both pre-pandemic and post-pandemic. This approach is drawn from the CMA RP3 2020 decision. We agree with the CAA's approach and agree that there should not be a mechanistic adjustment to reflect changes to NERL's own gearing of around 20% resulting from the covid-19 pandemic. However, in light of the bespoke approach taken to assessing NERL's cost of debt, we recommend that the implied overall cost of capital re-levered to a range of gearing assumptions is taken into consideration.

7. OTHER ISSUES

7.1. DEBT BETA

We do not wish to raise any issues with the proposed CAA use of a 0.05 debt beta.

7.2. OTHER COST OF DEBT INPUTS

We do not raise comments on the share of index-linked debt, weight on new debt or issuance and liquidity costs.

7.3. AIMING UP/ PERCENTILE CHOICE

We welcome the CAA's use of the mid-point of the range, following a considered approach, rather than assuming an automatic aiming up.

[20] CEPA (17 December 2021) 'Response to CAA H7 Initial Proposals: Cost of Capital'.

IMPORTANT NOTICE

CEPA
economics matters

UK

Queens House

55-56 Lincoln's Inn Fields

London WC2A 3LJ

T. **+44 (0)20 7269 0210**

E. **info@cepa.co.uk**

www.cepa.co.uk

Australia

Level 20, Tower 2 Darling Park

201 Sussex St

Sydney NSW2000

T. **+61 2 9006 1307**

E. **info@cepa.net.au**

www.cepa.net.au

cepa-ltd @cepaltd