

# Economic regulation of NATS (En Route) plc: Update on approach to the next price control review

CAP 2119



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## About this document

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This document provides an update on our approach to the next NATS (En Route) plc (NERL) price control, following our December 2020 consultation (CAP1994) on these matters.

This document builds on the previous consultation in providing more clarity about the CAA's approach to the next NERL price control review. In particular, this document aims to provide a direction of travel on the following issues:

- our approach to Traffic Risk Sharing (TRS) policy and 2020 and 2021 reconciliation exercise, together with our latest position for start date for the next price control (which we now intend to be January 2023);
- the high-level framework for the next price control review;
- pensions policy including the Pensions regulatory policy statement (RPS); and
- our current thinking on timetable and process issues for the next stages of our work.

### **Next steps**

Any responses to this consultation should be provided by 15 April 2021. We intend to update on our timetable before the end of May 2021 and publish a working paper on the reconciliation exercise by the end of June 2021.

If you would like to discuss any aspect of this document, please contact Matt Claydon ([matt.claydon@caa.co.uk](mailto:matt.claydon@caa.co.uk)).

# Summary and introduction

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## Background

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1. NERL<sup>1</sup> is subject to price controls that set the maximum charges that it can recover from airspace users for the provision of air traffic services (ATS) for its Eurocontrol en route, London Approach and Oceanic en route services.
2. We last made price control determinations on NERL's charges for Reference Period 3 (RP3) in 2019, which were intended to cover the period from 2020 until 2024. In making our RP3 decisions, as well as setting maximum charges, service quality targets and incentives, we introduced enhanced capital expenditure (capex) governance arrangements and incentives. We also set out roles for NERL in supporting the Airspace Change Organising Group (ACOG) and the creation of an airspace design masterplan for the UK.
3. NERL rejected our RP3 decisions and the determination was referred to the Competition and Markets Authority (CMA) to resolve. During the period when the CMA was considering the reference, Covid-19 emerged as a pandemic, with the resulting severe and unprecedented downturn across the aviation sector. Air traffic volumes in April 2020 were approximately 90% below April 2019 volumes. There has been a very modest, and variable, recovery since then. In August 2020, flights were approximately 60% lower than the previous year. By February 2021 this has fallen to approximately 79% lower than February 2019.<sup>2</sup> While there are stronger prospects for recovery in 2021, given the vaccination programmes now starting in many countries, there remains a significant degree of uncertainty about how recovery will develop. While the UK nations have set out their timetable for lockdown easing, including developing a roadmap towards resuming international travel on a large scale, the pace with which this travel will resume will also depend on the progress made internationally.
4. In reviewing our RP3 decisions early in 2020, the CMA decided that the impact of Covid-19 would be too difficult to assess properly as part of its determination and that we should review these matters when better information was available. The CMA established price controls covering the period January 2020 to December 2022, on the expectation that this would give the CAA enough time to set new price controls and better take into account the impact of the Covid-19

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<sup>1</sup> Abbreviations used in this consultation as well as references to previous CAA consultations are set out in Appendix A.

<sup>2</sup> Source: Network Manager, Eurocontrol.

pandemic and the path of recovery. The CMA also set out an expectation that a reconciliation exercise would be necessary for 2020 and 2021 with reference to actual flight volumes and costs over the period since the start of 2020. The CMA made its final report in July 2020.<sup>3</sup>

5. Overall, the CMA determination made a number of changes to NERL's capex incentives and allowed NERL a further approximately £34 million of revenue over the period 2020 to 2022, which represents a 1.8% increase compared to our original decisions, in respect of the main en route price control.<sup>4</sup> The majority of the increase relates to the CMA's decision not to reduce NERL's operating cost allowances in line with expected reductions in non-regulated revenue and an increase in the pre-tax weighted cost of capital (WACC) allowance from 2.91% to 3.48%.

## December 2020 consultation

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6. In December 2020, we published a consultation document (CAP1994) which set out our initial thinking on the key issues regarding our approach to the next NERL price controls in light of the impact of the Covid-19 pandemic. It addressed:
  - the short-term and longer-term policy challenges that we will need to consider in developing the regulatory framework for NERL;
  - policy options for addressing these challenges; and
  - the timetable and processes which we will need to follow in order to have new price controls in place in a timely manner.
7. In relation to the short-term, we said that we would adapt the current regulatory framework to take account of the impact of Covid-19 on the sector in 2020-2021. In doing so we would need to carry out a reconciliation of TRS arrangements and deal with issues around the regulatory treatment of pension costs. We would also need to take into account any acute short-term issues (including possible issues relating to NERL's financeability). We also said that our approach to these matters should allow for an appropriate transition to the regulatory arrangements that we will put in place for the next regulatory period.
8. With respect to the longer-term issues, we said that we would develop the future regulatory framework and price control arrangements from 2022 in a way that is flexible to uncertainty about future costs and the speed of traffic recovery, while

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<sup>3</sup> See the CAA's CAP1967 consultation on proposed modifications to NERL's licence conditions, Sept 2020: <https://www.caa.co.uk/cap1967>

<sup>4</sup> Based on data in Table F1, [Appendix F](#). CMA final report on NATS (En Route) Plc/CAA Regulatory Appeal.

also supporting both the affordability of NERL's charges to users and its financeability (in line with our statutory duties).

9. We noted that the interests of users would be served by NERL's charges being at a level that supports users in re-establishing and operating services, given the difficult circumstances created by Covid-19. However, we said that beyond this broad concept we have not yet crystallised a clear definition of affordability, and that in the difficult circumstances of Covid-19 it seems unlikely that we will be able to rely on a simple definition of affordability (such as no real increase in charges) and would welcome the views of stakeholders on these matters.
10. We also put forward a range of policy options designed to address the challenges we had identified and noted that stakeholders should not assume it will be appropriate to simply roll forward all the previous regulatory arrangements without modification. We said we would look to build on the existing arrangements where appropriate so that they properly support the affordability of NERL's charges and its longer-term financeability. More specifically, we said that we would seek to:
  - protect affordability by ensuring that NERL has appropriate incentives for efficiency, while also protecting the quality of service;
  - consider whether it is appropriate to take further steps such as recovering the revenue associated with the 2020 and 2021 reconciliation over an extended period;
  - address continued uncertainty regarding traffic volumes including how best to calibrate risk-sharing for the period from 2022;
  - proceed carefully so that we do not create undue risks for NERL that could lead to increases in the cost of capital, which in turn would feed into higher prices for users;
  - deal with short-term issues around affordability and financeability while ensuring the longer-term interests of consumers are properly considered;
  - ensure that the pension costs that are passed through to regulated charges will continue to be reasonable and affordable; and
  - not rule out NERL's providers of equity finance needing to provide additional support, to support both affordable charges and its business remaining financeable.
11. The December 2020 consultation also highlighted important process and timetable issues, including:
  - NERL's request that we provide confirmation on our approach to the TRS reconciliation, to support a refinancing of its bank facilities in 2021;

- the duration of the next main price controls and our view that, if it is practicable, we should set a five-year price control;
- the timetable for the price controls review and arrangements for NERL's next business plan; and
- how to ensure effective customer engagement.

## Summary of this document

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12. This document provides an update on our thinking in respect of the challenges and policy options which we identified in the December 2020 consultation and explains how we have responded to the views set out in the consultation responses. In particular, this document aims to provide a direction of travel on the following price control issues:
  - approach to Traffic Risk Sharing (TRS) policy and 2020 and 2021 reconciliation exercise, together with our latest position for the start date for the next price control (which we now intend to be January 2023);
  - the high-level framework for the next price control review;
  - pensions policy including the Pensions RPS; and
  - our current thinking on timetable and process issues for the next stages of our work.
13. This update focuses on stakeholder responses in relation to the subjects above. It does not cover in detail all the policy areas touched on in the December 2020 consultation or subsequent representations, such as service quality performance and incentives, investment programme (including Airspace Modernisation Strategy), business plan guidance and review of Oceanic Automatic Dependent Surveillance-Broadcast (ADS-B). These will be considered in due course.
14. Overall, we intend to continue with the broad approach set out in December 2020, including in respect of the reconciliation of TRS arrangements. The main development in our policy and approach is that we intend now to rely on the price control arrangements put in place by the CMA for 2022 and defer the start of the next main price control period and the recovery of revenue from the reconciliation exercise to the five-year period starting in 2023. This will protect the affordability of charges in 2022, should support NERL's financeability in 2022 and is consistent with the views of respondents to the December 2020 consultation. We consider that taking more time to set a price control starting in 2023, rather than 2022, will provide a better opportunity to set a longer-term price control given there should be better information, and the potential for more certainty, about the likely path of traffic volumes and costs.

15. Nonetheless, there will be remaining uncertainties around traffic volumes and NERL's costs by starting the price control in 2023. As a number of respondents to the December 2020 consultation have noted, there may be a tension between affordability and financeability, particularly as by starting the new control period in 2023 we will create the need for an additional year of reconciliation. Specifically, this reconciliation will have the effect of pushing out the recovery of costs into the future – meaning that there may be more pressure on affordability and financeability. To the extent it is practicable we will seek to address any such difficulties by using conventional regulatory levers, such as spreading the recovery of revenue over a greater period of time, but as we noted in the December 2020 consultation, given the ongoing uncertainty, we cannot at this stage rule out setting price control arrangements on the basis that NERL's shareholders provide additional support to its regulated business. However, we note there has been positive progress since that consultation with regards to developing a roadmap to resume international travel at scale, alongside positive steps that NERL has made in respect of its overall refinancing, which has the potential to allow NERL to better support affordable charges and the recovery of the sector.
16. NERL has significant pension liabilities, in particular in relation to its defined benefit pension scheme. It has taken steps to mitigate these costs, including closing the scheme to new joiners in 2009. However, the scheme has strong legal protections and NERL's obligations remain a significant part of its costs base. We consulted on a draft RPS in the December 2020 consultation to provide further clarity to NERL and its pension trustee on the regulatory treatment of pensions. We expect this to provide benefits to consumers in the long-term by reducing uncertainty and the expected costs of NERL's pension liabilities. Respondents to the December 2020 consultation broadly supported a RPS and we discuss further in chapter 2 the approach we have taken to finalising the Pensions RPS (which is set out in Appendix C).
17. Delaying the new price controls until 2023 will allow more time to consider emerging traffic forecasts and the shape of industry recovery, and the development of credible and robust business plans for the forthcoming regulatory period. It is also expected that new statutory provisions introduced by the Air Traffic Management and Unmanned Aircraft (ATM and UA) Bill will change the licence modification process and appeal rights, which will need to be factored into the forward review timetable. We discuss the timetable for the review in chapter 3 and will engage with stakeholders further on these matters.
18. Our plans for further deliverables during 2021 include an update on the timetable and a working paper on our approach to the 2020 and 2021 reconciliation review. This working paper will focus primarily on TRS, but we will also consider whether we should make changes to compensate for any incentive arrangements that might produce significant and perverse outcomes in the

circumstances of Covid-19. Later in 2021 we will consult on the necessary licence modifications (and any appropriate consequential changes) to prevent the automatic operation of the TRS mechanism for under recoveries from 2020 in the 2022 unit rate, and set out the principles that will allow the recovery of these revenues in the future.

## **Our duties and the regulatory framework**

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19. In developing this consultation, we have had full regard to our statutory duties under the Transport Act 2000 (TA00), which are set out in Appendix B.

### **Wider statutory framework**

#### **UK/EU transition**

20. NERL has been subject to an economic regulatory framework under the TA00 and its licence since its privatisation in 2001. Since 2012, it had also been subject to the EU Single European Sky (SES) performance scheme for air navigation services (ANS). The performance scheme is established under EU regulations, which no longer apply in the UK. As of 1 January 2021, the economic regulation of NERL reverted to being solely under the framework provided by the TA00 and NERL's licence.
21. Our TA00 obligations include taking into account, as appropriate, requirements on the UK as a member of Eurocontrol,<sup>5</sup> including a common policy on en route charges as set out in the Eurocontrol Charging Principles.<sup>6</sup>

#### **ATM and UA Bill**

22. Proposed amendments to aspects of the licensing regime for the economic regulation of ATS in the TA00, are currently being considered under the ATM and UA Bill, which is progressing through Parliament.<sup>7</sup> Part 2 of the ATM and UA Bill focuses on ATS and updates the licensing framework for economic regulation that governs the provision of ATS. It will modernise the current licence modification and enforcement provisions in Part 1 of the TA00, in line with best regulatory practice. The proposed provisions contain a more comprehensive suite of regulatory and enforcement tools, including a new procedure for the CAA to modify licence conditions and a new power for the Secretary of State to amend terms of the licence. There will also be new rights for NERL (as the licence holder), airspace users and airports whose interests are materially affected, to appeal licence modification decisions to the CMA. Additionally, the ATM and UA Bill includes provision for enforcement in respect of a breach of a

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<sup>5</sup> Eurocontrol provides a Central Route Charges Office, which manages the collection of unit rates on behalf of its member states.

<sup>6</sup> [Principles for establishing the cost-base for en route charges and the calculation of unit rates.](#)

<sup>7</sup> [Air Traffic Management and Unmanned Aircraft Bill \[HL\] 2019-21](#)

licence condition or statutory duty, which NERL can appeal to the Competition Appeals Tribunal (CAT).

## Views invited

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23. The primary purpose of this document is to update stakeholders on our policy position for the next main price control review, which we now intend to carry out over the remainder of 2021 and 2022, with new arrangements implemented from January 2023.
24. If stakeholders have any comments on the material set out in this consultation or any associated issues then they should send these to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) no later than 15 April 2021.

## Structure of this document

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25. The structure of this document is as set out below.
  - Chapter 1 sets out our updated thinking on the TRS arrangements and 2020/21 reconciliation, together with that on the start date and duration of the next price control. It also covers our updated thinking on the framework for our approach to the next NERL price control more generally.
  - Chapter 2 sets out our final policy position on the RPS for Defined Benefit pensions costs.
  - Chapter 3 sets out our updated thinking on the timetable and process issues including deliverables for the next NERL price control.
26. The appendices provide the Pensions RPS as well as providing information on our duties and a guide to the abbreviations used in this document.

## Chapter 1

# Reconciliation of TRS arrangements and next price control review

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## Introduction

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- 1.1 This chapter summarises the responses we received to the December 2020 consultation, and sets out our updated thinking on:
- the TRS arrangements and reconciliation for 2020 and 2021;
  - the start date and duration of the next price control; and
  - our broad approach to developing the regulatory framework for NERL during the next price control review.

## Reconciliation of TRS arrangements for 2020 and 2021

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- 1.2 The December 2020 consultation said that we would need to carry out a reconciliation of the TRS arrangements for 2020 and 2021 and integrate the recovery of an appropriate level of revenue in our proposals for the next price control. We said that we expected the new price control to commence in 2022 and, if practicable to set on this basis, have a five-year price control.
- 1.3 Respondents generally supported our intention to revisit the TRS mechanism to avoid a steep increase in charges which could be unaffordable. However, there were different views on the extent to which some, or all, of the shortfall in revenues should be met by the amended TRS arrangements or a combination of TRS, Government and shareholders. Many respondents questioned whether it was reasonable for the amended TRS arrangements to allow for the recovery of all costs from users. Some suggested that some, or all, of any shortfall in revenue should instead be met by a combination of the Government and shareholders.
- 1.4 Some respondents provided more detailed views on the range of possible options for approaching this reconciliation exercise. Further details of responses are provided below.

### Airspace users

- 1.5 There was general support from airspace users and IATA for amending the TRS mechanism by adopting a similar approach to the European Commission (EC), which involves establishing new cost baselines and extending the recovery period. However, users also wanted to avoid a steep increase in charges that might occur with the recovery of TRS revenue from 2022. Some users suggested

that meeting the shortfall in revenues brought about by travel restrictions should be the responsibility of shareholders and/or Government.

- 1.6 Users were of the view that the 2020 and 2021 reconciliation should reflect efficient, not actual, costs. There was a range of views as to the appropriate approach to this reconciliation exercise including:
- a variance analysis which would allow users to see where NERL's spend was not considered to be in line with efficient cost levels;
  - a review of NERL's accounts to provide a basis for determining the level of costs to be recovered; or
  - a combination of a review of specific price control 'building blocks' (e.g. the regulatory allowance for operating costs) and more detailed variance analysis.

## **NERL**

- 1.7 NERL broadly supported a temporary adjustment to the TRS, based on the approach which has been adopted by the EC, and said that this should help avoid an unaffordable increase in charges. It said that, as well as affordability, the CAA should take account of its statutory duties in relation to NERL's financeability and the longer-term advantages of NERL being able to invest in a resilient service. NERL also said its shareholders are already contributing to keeping the business financeable and that it would be important that the approach to regulation did not increase its cost of capital and have an adverse impact on the affordability of its charges in the longer term.
- 1.8 NERL set out some of the 2020 cost reduction measures taken and highlighted their exceptional nature. It suggested the approach to the reconciliation should focus on price control building blocks and it would aim to present evidence on key factors affecting the most important cost elements, including rationale for changing some items and maintaining others. NERL said that a detailed review, similar to submission of a business plan, would distract users and NERL from important activities to support recovery of the sector.

## **Other respondents**

- 1.9 HAL supported the spreading of TRS recovery to smooth the impact on charges. However, it argued that the CAA should maintain regulatory consistency and honour the TRS mechanism as otherwise investors' perceived regulatory risk will increase leading to higher cost of capital in the future.
- 1.10 Prospect said that the EC's amendments to the performance scheme provide a reasonable basis for reconciling charges and would be a good starting point for the UK. However, it pointed out that the TRS mechanism is fundamental to NERL's financeability and any adjustments that put more risk on to NERL

would ultimately lead to users bearing additional costs. Prospect also said that there should be no efficient costs test applied retrospectively to NERL's costs in 2020.

1.11 GATCO also supported the spreading of recovery over five to seven years.

## CAA updated thinking

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- 1.12 Consistent with our statutory duties we are seeking to develop an approach which delivers both affordable charges and supports NERL's financeability and efficient operation. In line with the approach set out in the December 2020 consultation we intend to:
- reconcile costs and revenues for 2020 and 2021 on the basis of estimates of efficient costs (which might be lower than actual costs if we find evidence of inefficiency);
  - allow the recovery of revenue shortfall over a longer period than the current two-year time lag for recovery, with the arrangements that have been proposed by the EC being an important benchmark (i.e. over a five to seven year period from 2023);
  - to the extent practicable, seek to allow the full recovery of revenue consistent with supporting NERL's financeability. This recovery may need to be over an extended period and should be consistent with affordable charges that support the recovery in traffic levels; and
  - carry out further work as part of the next price review on what affordability should mean in practice.
- 1.13 If these arrangements were to put significant pressure on the affordability of charges we cannot at this stage, given ongoing and future uncertainty, completely rule out setting price control arrangements on the basis that NERL's shareholders may need to provide additional support to the regulated business. In reaching any such view we would seek first to use conventional regulatory levers and mechanisms to manage affordability, take account of wider price control package, and consider our statutory duties, including to protect the interests of consumers and to have regard to NERL's financeability.
- 1.14 One respondent suggested that by revisiting the TRS mechanism, we could be creating a perception of additional regulatory risk. We do not agree and note that the current TRS mechanism includes a carve out provision in the current exceptional circumstances (as traffic variations are beyond the 10% threshold) and that an approach to addressing these matters consistent with our statutory duties should not create any undue regulatory risk.
- 1.15 To support a review of the efficient cost baseline for 2020 and 2021 we remain of the view that a focused review of specific building blocks, some form of variance

analysis, or a combination of the two, are likely to be the most proportionate approaches to carrying out this reconciliation. However, the requirements on NERL and airlines to provide the information required to support either approach must be reasonable and achievable. Therefore, we will further consider these options, including on the form and quantity of the information we require. We will seek to complete this review as far as practicable during 2021, although we note that we will only have forecasts of 2021 costs during this period and we will need to consider whether we should finalise our estimates in 2022.

- 1.16 Some respondents have suggested that some or all of the shortfall in revenue for 2021 and 2022 should be met by a combination of Government and/or shareholders. As noted above we do not completely rule out assuming a contribution from shareholders given current uncertainty, but we would first utilise conventional regulatory levers and mechanisms to manage affordability. We also recognise the positive steps NERL is taking in relation to its current refinancing. Finally, it is important to note it is not our role to decide whether further Government support should be provided as an alternative to regulatory intervention and we have not considered these matters further.

## **Duration of the CMA's interim arrangements and the start of the next main price control**

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- 1.17 In the December 2020 consultation, we set out the challenges and issues in the context of establishing new price control arrangements from January 2022. A number of respondents (including both NERL and users) suggested that in the light of these challenges it would be better to allow for greater time to properly complete the price control review and that we should start the next main price control from January 2023.
- 1.18 We can see there could be benefits to consumers from this approach and intend to adopt this broad approach for the price control review, provided that we modify the TRS arrangements for 2022 to defer the recovery of revenue from 2020 to the new main price control period, that we now intend should start in 2023. This would mean that unit charges for 2022 are set at the existing levels determined by the CMA (which did not take account of the impact of Covid-19 on traffic forecasts and costs) and so should reflect levels that are reasonably affordable. In contrast, a price control reset in 2022 could put upward pressure on charges for 2022, which is likely to be an important year for the recovery of traffic. We also need to consider NERL's financeability and note that NERL has stated that it does not consider the application of 2022 unit charges based on the CMA determination and a price control reset in 2023 would create material additional issues for its financeability.
- 1.19 Nonetheless, this would also create the need for a reconciliation for 2022 as the CMA left the existing TRS arrangements in place. We intend to adopt a similar

approach to the reconciliation for 2020 and 2021, but we would be more reliant on forecast information. Therefore, our expectation is that we would need to base the 2022 reconciliation on forecast, as opposed to actual, costs and we would welcome any views on this expected approach.

- 1.20 This means that during 2021, we will do the work necessary to propose and implement a modification to NERL's licence to replace the current TRS mechanism, which would otherwise allow NERL to recover 2020 revenue shortfalls in 2022 and cause a large increase in charges. We do not expect to have completed the reconciliation activity by the time we make the licence modifications, but will set out the process for completing the reconciliation as part of the consultation process that will support the licence modification.

## Future regulatory framework

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- 1.21 The December 2020 consultation said that in developing an approach to new price controls we would need to develop affordable charges for users and a sustainable financial position for NERL. We identified four particular challenges:
- dealing with uncertainty around traffic volumes;
  - identifying efficient levels of costs;
  - setting effective incentives; and
  - maintaining an efficient cost of capital.
- 1.22 We said that we will need to consider these challenges together to develop a coherent approach to our work on NERL's regulatory framework. As far as practicable, we would retain the key aspects of NERL's current framework and make changes only where necessary.

## Summary of responses

### Airspace users

- 1.23 Users strongly supported affordability as a driver of policy. However, they had different views as to how affordability should be defined. Some considered affordable charges would be those which would not increase in real terms while others considered that charges would need to decrease in order to remain affordable.
- 1.24 Users recognised the importance of efficiency in achieving affordable charges and highlighted the importance of comprehensive and transparent engagement with them in identifying these efficiency savings.
- 1.25 One user pointed out that one approach to achieving more affordable charges would be to defer the start of depreciation charges in addition to increasing the

number of years over which it is recovered. It also suggested that NERL should forego dividend payments rather than increase charges.

- 1.26 Despite the focus on affordability, users recognised the importance of ensuring that NERL is able to deliver efficient long-term investment programme and support airspace modernisation.

## **NERL**

- 1.27 NERL said the best way to support affordability is to extend the period over which NERL recovers the revenues from the 2020 and 2021 TRS reconciliation. Affordability can also be delivered by deferring and moderating the projected increase in charges from 2023. It also noted the CAA should assure itself that both the short-term and long-term impacts on customer affordability have been duly considered, noting that short-term affordability improvements to airlines could result in higher prices over the longer term if there is a transfer of risk from users to NERL.
- 1.28 NERL suggested that the regulatory framework should also support financeability by continuing to allow it to raise both debt and equity in an efficient manner. In particular, supporting an efficient refinancing of bank facilities in 2021 would require an approach to developing the regulatory framework that effectively limits NERL's risk exposure over the coming years and avoids any undue increases in its cost of capital.

## **Other respondents**

- 1.29 HAL agreed with the principle that affordability and ensuring that charges are set at a level that supports re-establishing traffic will be important but pointed out that affordability should not be prioritised above long-term user needs. It also said changes to TRS and changing the recovery of pension costs may be incompatible with ensuring financeability.
- 1.30 Prospect said that the affordability challenge is outside of the scope of the TA00 and that the CAA places too much emphasis on the interests of airlines. It considered that passengers will continue to accept the average £1 per flight cost to maintain the safety and quality of service they have become used to.
- 1.31 On efficiency, Prospect suggested that staff cuts are likely to increase the costs of the long-term investment programme by increasing the requirement for consultants and contractors to support projects. Furthermore, significantly reducing capex would delay technological upgrades that will have capacity, cost and environmental benefits.

## Way forward

- 1.32 Consistent with the December 2020 consultation we intend to develop an approach to a new price control which results in affordable charges for users and supports financeability.
- 1.33 We do not intend to adopt a simple definition of affordability such as ‘no real increase in charges’ given the complex and very challenging circumstances of Covid-19 and the need to act in a manner best calculated to comply with our statutory duties. Specifically, we consider that affordable charges are those which are set at a level that broadly supports users in re-establishing and operating services. This means that prices could increase in real terms, particularly in the medium term, provided this is needed to finance efficient investment and provide the service levels desired by users. We will carry out further work on what affordable charges should mean in practice as the price control review progresses.
- 1.34 We also intend to:
- consider how best to deal with traffic volume risks beyond 2022;
  - focus on providing appropriate incentives for efficiency, to aid affordability, while also protecting the quality of service; and
  - develop the regulatory framework to support NERL’s financeability, its capacity to invest in the longer-term and avoid any undue increases in its cost of capital.
- 1.35 We plan to build on the existing arrangements wherever possible and appropriate. This will involve retaining the key aspects of NERL’s current framework and only making changes to deal with the increased level of uncertainty and the greater challenges associated with financeability and affordability.
- 1.36 As noted earlier in this chapter the main development in our policy approach is that we now intend to rely on the price control arrangements put in place by the CMA for 2022 and defer the next main price control period and the recovery of revenue from the reconciliation to the five-year period starting in 2023.
- 1.37 Looking ahead to the price control period starting in 2023 is not straightforward because of the uncertainties around traffic volumes and NERL’s costs. Nonetheless, if difficulties emerge with the affordability of NERL’s charges then to the extent it is practicable we will seek to address any such difficulties by using conventional regulatory levers, such as spreading the recovery of revenue over a greater period of time, but as we noted above and in the December 2020 consultation, given the current uncertainty, we cannot, at this stage, completely rule out setting price control arrangements on the basis that NERL’s shareholders provide additional support to its regulated business. However, we

note that there has been positive progress since that consultation with regards to developing a roadmap to resume international travel at scale, alongside positive steps that NERL has made in respect of its overall refinancing, which has the potential to allow NERL to better support affordable charges and the recovery of the sector.

## Chapter 2

# Pensions

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## Introduction

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- 2.1 Defined benefit (DB) scheme pension costs are an important element of NERL's cost base, both in terms of ongoing contributions to the scheme and pension deficit repair costs (PDRCs). In the price control calculations that the CMA made for RP3 these elements represent around 10% of NERL's determined costs.
- 2.2 In our RP3 final decisions and in the CMA's final determination for RP3, we said that we were planning to prepare a regulatory policy statement (RPS) for pension costs. The purpose of the RPS is to provide further clarity to NERL and its pension trustee on the regulatory treatment of pensions. We expected this to provide benefits to consumers in the long-term and for the next triennial valuation of NERL's pension liabilities at the end of 2020.
- 2.3 The December 2020 consultation included a draft RPS. This chapter summarises the responses to this consultation and explains our approach to finalising the Pensions RPS. The final version of the RPS is set out in Appendix C.

## Summary of responses

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### NERL

- 2.4 NERL strongly supported the principle of an RPS and in very large part the contents of the draft RPS. It estimated a potential benefit for consumers of £320 million, as at November 2020.
- 2.5 NERL's primary concern on the wording of the RPS related to the references to "affordability" of pension costs. NERL was concerned this term is subjective, does not recognise the legal constraints and impacts of external events, can only be assessed in the context of NERL's overall business plan rather than in isolation and implies a short-term regulatory judgement on investment risk without regard to longer-term obligations and the interests of future consumers.
- 2.6 NERL recommended that the RPS should make reference to "efficient" pension costs, assessed by reference to factors such as the assumptions underlying the scheme valuation, the stewardship of the scheme and the investment strategy.

### Civil Aviation Authority Pension Scheme (CAAPS)

- 2.7 CAAPS Trustee Ltd, the Trustee of the NATS Section of CAAPS (the Trustee), welcomed the publication of the draft RPS for consultation. It expected that an

acceptable RPS would reduce future pension costs, although noted that the RPS should be drafted in a way that recognises the Trustee's primary responsibility to scheme members and that it has its own legal and regulatory responsibilities.

2.8 The Trustee raised a number of specific points about changing wording in the draft RPS (references below are to paragraphs in the draft RPS):

- the removal of references in the draft RPS that put obligations on the Trustee to consider the interests of consumers and provide evidence on how they have managed the pension cost burden, where these obligations should only be on NERL (in paragraphs 3, 4, 5, 7, 17 and 19);
- a request to extend the RPS to cover changes in pension costs that arise due to unforeseen changes in 'demographic assumptions' (paragraphs 26 and 27);
- a request that there should be consistency in the CAA's approach to considering whether a change is 'unforeseeable' or 'unforeseen' (paragraph 28);
- a request that all changes, not just material changes, to the RPS should be subject to consultation (paragraph 30);
- a request that the introduction of any changes to the RPS should be aligned with the notice period of NERL's licence (paragraph 30); and
- clarifications on the treatment of surpluses consistent with the scheme rules (paragraph 18) and that the principles in the RPS do not cover the other non-regulated entities in the NATS Group (paragraph 23).

2.9 The Trustee stated that, subject to addressing the concerns raised in its response, it would be able to act consistently with the principles in the proposed RPS.

### **Airspace users**

2.10 IATA generally welcomed the draft RPS and raised some specific questions on the wording, including:

- whether NERL employees eligible for a defined benefit pension are included in the definition of 'all stakeholders' who should play a part in helping manage future pension costs (paragraph 9 of the background section);
- for the term that pension costs should 'remain affordable' to be replaced with 'efficiently incurred relative to suitable benchmarks' (paragraph 4);
- for clarification on what it means that the Trustee and NERL should 'take account of' relevant costs and consumer benefits and whether there is an objective against which the CAA would judge this (paragraph 15);

- whether there is (and how we would resolve) any conflict between our expectations and how NERL/Trustee would manage any surplus effectively and efficiently in the best interest of users (paragraph 17); and
- whether the obligations on NERL go beyond it just providing information to demonstrate how the interests of users have been properly taken into account, and what we would do if we disagreed with NERL's approach (paragraph 18).

2.11 Ryanair stated that pension costs need to be managed very carefully and that while considered to be a 'pass-through' cost, this should only increase NERL's focus on the impact these costs will have on users.

2.12 easyJet agreed with the CAA that users should only pay for pension costs that are reasonable. They set out that any current shortfall in the NATS pension fund, including that resulting from Covid-19, should not be passed on to users.

### **Prospect**

2.13 Prospect welcomed the principle of an RPS, which it considered should increase certainty and confidence and result in more modest pension costs.

2.14 It stated that Section 2 of the RPS is the useful element but that Section 1 is superfluous, as it largely contains a list of expectations from the CAA to NERL and the Trustee, many of which are already covered in pension law and are outside the direct remit of the CAA.

2.15 It considered that pension costs largely should be accepted for what they are and should be left to NATS and the Trustee – who have a track record of excellent stewardship – to continue to manage them appropriately.

### **Way forward**

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2.16 We continue to support the principle of an RPS on the basis that it should provide benefits to consumers in the short and longer term and recognise the broad stakeholder support for an RPS. We also expect the Trustee will take this RPS into account in its valuation of the defined benefit pension scheme as at 31 December 2020.

2.17 We have carefully considered the comments made by stakeholders and where appropriate have made changes to the draft RPS to reflect these comments. These issues are discussed further below and the final RPS is set out in Appendix C.

### **Changes to the draft RPS**

2.18 Having considered the views of respondents we have made the following changes to the draft RPS:

- noting the concerns expressed by NERL and IATA that the wording around ‘affordability’ should instead make reference to the efficiency of pension costs we accept that pension costs should not be seen in isolation when thinking about affordability of user charges and that it would be inappropriate to focus on short-term cost reductions where this leads to higher costs to consumers over the longer-term. We have made some changes to the wording in the RPS to reflect these concerns (for example, in paragraph 4). This would still mean that we expect NERL, in working with the Trustee, to consider and take all measures to ensure pension costs are efficient and reasonable, to the benefit of consumers now and in the future. We consider this should be consistent with our aim of overall user charges being affordable, to be assessed at the price control and taking account of the longer-term, rather than a narrow assessment of short-term pension costs, and our statutory duties;
- acknowledging that the primary responsibility of the Trustee is to scheme members. We see broad alignment between this objective and the interests of consumers, as pension costs should continue to be reasonable and efficient to support ongoing funding by users. We have made the requested changes throughout the RPS<sup>8</sup> to clarify that the obligations to manage pension costs should be on NERL, working with the Trustee. This is consistent with the Trustee’s primary responsibility, while continuing to recognise the Trustee’s important role in working with NERL to provide efficient and reasonable pension costs to the benefit of consumers;
- accepting the suggestions by the Trustee that all changes to the RPS, not just ‘material’ changes should be subject to consultation (in paragraph 30). This approach would avoid disagreements over the materiality of any changes; and
- clarifying the wording on the treatment of any surplus (paragraph 18) and the scope of the RPS in not applying to other entities within the NATS Group (paragraph 23).

## Responses to other comments made by stakeholders

2.19 There are some comments from stakeholders where we have not proposed to make changes to the RPS. We have not:

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<sup>8</sup> For example, changes made to wording in paragraphs 3, 4, 5, 17 and 19.

- extended the RPS to cover unforeseeable changes in ‘demographic assumptions’, as requested by the Trustee. This has not been a material factor in causing unexpected changes in pension costs during the RP2 period. While the demographic assumptions can change, we would expect them to be more stable and change more slowly than financial market conditions;
- changed the wording around assessing unforeseen or unforeseeable changes in pension costs (paragraph 28) as we should retain the flexibility to make our assessment taking account of the circumstances at the time. Nevertheless, we agree with the Trustee that we should apply a consistent approach where practicable, in line with the principles of better regulation<sup>9</sup>;
- accepted that changes to the RPS should be aligned with the notice period of NERL’s licence (currently 10 years<sup>10</sup>). While our current expectation is that the RPS should apply across multiple price control periods we cannot rule out the need for change and have committed to consult on any changes and the appropriate notice period for making any such changes;
- amended the wording around our expectations on NERL to show it has taken account of consumer interests and our response if NERL does not meet these expectations, in response to comments from IATA (paragraphs 15 and 18). We would need to take account of the circumstances in place at the time in determining an appropriate response if NERL were to act inconsistently with our expectations and so we do not intend to make these changes; and
- removed Section 1 of the RPS, as suggested by Prospect. This provides important information on our expectations for NERL, in working with the Trustee, to make sure pension costs are efficient and reasonable.

2.20 In addition, we respond below to other comments and questions made by stakeholders relating to pension costs and the RPS:

- on IATA’s question on the definition of ‘all stakeholders’ (paragraph 9 of the background section), we clarify that we were referring particularly to NERL, its shareholders and users. This was not intended to cover defined benefit scheme members where there are specific legal protections in place (such as in the Trust of a Promise document);

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<sup>9</sup> <https://www.caa.co.uk/Our-work/About-us/Better-Regulation/>

<sup>10</sup> We note further that the Air Traffic Management and Unmanned Aircraft Bill contains certain provisions that would allow the Secretary of State to amend this term.

- on IATA's question about our expectations on NERL managing a surplus (paragraph 17), we do not consider there to be a conflict. It is appropriate to set out our expectation in the RPS as the treatment of surpluses was an issue we identified during the RP3 price controls review;
- on IATA's question on the pension cash alternative (PCA) and the defined contribution (DC) scheme, the assessment of efficiency of these costs is outside the scope of the RPS, which focuses on DB costs;
- we agree with Ryanair that pension costs need to be carefully managed and any future pass-throughs will continue to need to be well-evidenced by NERL and scrutinised effectively by the CAA;
- we do not agree with Prospect that pension costs should simply be accepted, as this does not align with assessing these costs to make sure they are efficient; and
- we agree with easyJet that pension costs should be reasonable although we do not agree that this means that the cost of shortfalls in NATS' pension fund should not be passed on to users. We consider that only reasonable and efficient costs should be passed to users, which would provide benefits to consumers by maintaining an efficient cost of capital and not make it unduly difficult for NERL to finance itself.

## Final policy

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- 2.21 The final version of the CAA's RPS for NERL's DB pension costs is set out in Appendix C. It has immediate effect and can be taken into account by NERL and the Trustee, including in the context of the December 2020 valuation of the NATS Section of the CAAPS. We expect that the RPS will be in place for the longer-term, but if it appears that any changes are necessary or appropriate we will consult stakeholders on these changes and the appropriate notice period for introducing any such change.

## Chapter 3

## Process and key deliverables

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### Introduction

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- 3.1 The December 2020 consultation highlighted important process and timetable issues, including the arrangements for NERL's next business plan and how to promote effective engagement between NERL and its customers.
- 3.2 This chapter sets out our developing thinking on these matters, with a focus on the broad timetable for the price review and our future deliverables.

### Consultation responses

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- 3.3 NERL said that it needs a minimum of nine months to develop a business plan. It expects to receive detailed guidance from the CAA about traffic, targets and other key assumptions although it says the EU performance targets (due to be adopted by the EC by 1 May 2021) could provide a reference point for the UK.
- 3.4 It suggested that its business plan should focus on issues of traffic recovery and associated topics around capacity, resilience, service levels and investment to support recovery. It said it will not be necessary to revisit certain topics that were evaluated as part of RP3 or the CMA review, including cost allocation, non-regulated revenue or capex governance.
- 3.5 NERL proposed six weeks of customer workshops focussing on traffic, targets (including cost efficiency), capex and the Oceanic price control. It says that its airline and airport customers will have limited capacity to engage before summer 2021.
- 3.6 One user suggested that NERL should provide stakeholders with the full disclosure of financial information, forecasts and assumptions to demonstrate the fair basis for charges, cost-relatedness and cost efficiency. In addition, it considered that stakeholders should be consulted in a transparent and non-discriminatory way and their views should be properly considered.

### Timetable

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- 3.7 Chapter 1 explains the advantages of delaying the start of the new price control until January 2023, including allowing sufficient time for NERL to develop its business plan. We also explained that this will require a reconciliation for 2022 of TRS arrangements, in addition to the reconciliation for 2020 and 2021 that we discussed in the December 2020 consultation.

- 3.8 We fully support the need for customer engagement and strongly encourage NERL to establish a customer engagement strategy and timetables as part of its business planning process. However, we also recognise the likely resource constraints on users and so NERL will need to ensure its engagement processes are as efficient and effective as practicable.
- 3.9 Our current understanding is that the ATM and UA Bill is likely to have come into force before the setting of the new price controls and that this will change the process and requirements for both licence modification and the appeals process under the TA00. The proposed amendments<sup>11</sup> include a change to the licence modification process and a replacement of the CMA reference process with an appeal process, as follows:
- the CAA may modify NERL's licence, without requiring NERL's consent, which is currently required under section 11(1) TA00. However, before modifying NERL's licence, the CAA must still consult relevant parties on the proposed licence modifications for a 'reasonable period'. The current requirement under section 11(3) TA00 is for the consultation on proposed licence modifications to be 'not less than 28 days'. We consider this standard would also satisfy the new 'reasonable period' requirement;
  - following that statutory consultation, the CAA must publish a notice setting out, among other things, the modifications it intends to make to NERL's licence and the date, not less than six weeks from the date of the notice, on which the modifications will come into effect (subject to any appeal process); and
  - if NERL or any airspace users or airports whose interests are materially affected wish to appeal the CAA's decision, they must make an application to the CMA within the six-week period noted above.
- 3.10 On the basis that the proposed amendments set out above are in force, to implement new price control arrangements from January 2023, the latest dates for these key steps in the statutory process would be as follows:
- September/ early October 2022: CAA final decisions and 28-day statutory consultation;
  - mid November 2022: CAA decision on and publication of notice of licence modifications; and
  - January 2023 new price controls come into effect.

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<sup>11</sup> Part 2 of the ATM and UA Bill as at the date of publication of this document ([Air Traffic Management and Unmanned Aircraft Bill \[HL\] 2019-21](#))

## Overall timetable

3.11 During the last RP3 review in 2018 and 2019 the timetable worked as follows:

| RP3 review timetable |                      |  |               |
|----------------------|----------------------|--|---------------|
| 2018                 | January              | CAA publishes business plan guidance to NERL       | } c.10 months |
|                      | May                  | NERL issues initial business plan                  |               |
|                      | May to September     | NERL customer consultation activities              |               |
|                      | October              | NERL revised business plan                         |               |
| 2019                 | February to April    | CAA consultation on initial proposals              | } c.10 months |
|                      | July                 | CAA decision on final proposals                    |               |
|                      | August               | CAA publication of final proposals                 |               |
|                      | November             | Reference to the CMA                               |               |
| 2020                 | July                 | CMA report   |               |
|                      | September to October | Statutory consultation on licence modifications    | } 4 weeks     |
|                      | December             | Decision and notification of licence modifications |               |

3.12 Mindful of the duration of key elements of the RP3 review we consider that a similar timeline (10 months) will be required for our work on the main price review in 2022, during which time we would envisage:

- assessing NERL's business plan and consider expert advisers' findings;
- developing, and consulting stakeholders on, our initial proposals;
- updating, and then conducting the statutory consultation on, our final proposals;
- making decisions on the new price control; and
- then notifying the necessary licence modifications six-weeks in advance of them coming into effect.

3.13 Considering the ongoing uncertainty of traffic and industry recovery and these challenging timetable requirements, NERL, other stakeholders and the CAA will need to consider more flexible and agile approaches to engagement – including working in parallel where practicable – to deliver and implement new price controls by 1 January 2023.

3.14 Bearing the above in mind, our current view of the timetable is that NERL should use the nine months from April to the end of 2021 to engage with users, airports

and the CAA to develop and deliver its business plan. This would allow a similar period in 2022 for us to develop and consult on initial proposals, make any updates and then make a decision on final proposals for statutory consultation in October 2022.

- 3.15 NERL has also requested direction on a number of business planning assumptions. We provided extensive guidance about development of the business plan for RP3. We consider that at a broad level, much of that guidance remains appropriate. However, we will engage with NERL and other stakeholders on whether additional guidance should be provided and the areas that it would be most beneficial for it to cover. We also note that NERL should work with its users to better understand what users want from its business plan and how users can best input into the process for developing the plan.
- 3.16 We will also engage further with stakeholders in the coming weeks to develop a provisional timetable on this basis and publish an update as soon as practicable.

## Key CAA deliverables for 2021

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- 3.17 Key CAA deliverables in 2021 for this review include:
- timetable update – following the further engagement above, in May 2021 we intend to publish a timetable update for the remainder of the review. This will address any outstanding issues with respect to NERL business plan guidance, the customer engagement process and the finalised timetable for the price control review;
  - reconciliation working paper – by the end of the second quarter of 2021, we will issue a working paper setting out our approach to the 2020 and 2021 reconciliation review, including the information we will require from NERL and how we will engage with stakeholders on our emerging findings; and
  - consultation on licence modifications for 2022 – by the end of the third quarter of 2021, we will consult on modifications to NERL’s licence to prevent the automatic operation of the existing TRS mechanism that would allow under recoveries from 2020 to be included in the 2022 unit rate. We expect this consultation to also address the policy principles that will guide our approach to the recovery of revenue from the 2020 to 2022 reconciliations, to provide comfort to NERL and wider stakeholders on our approach to these important matters. The licence modifications may also include other relevant and/or consequential changes, such as the treatment of service quality incentives as well as updates to terms and definitions as necessary, where appropriate taking into account the Eurocontrol Charging Principles.

## APPENDIX A

## Abbreviations

| Abbreviations |  |
|---------------|--|
| ACOG          | Airspace Change Organising Group                     |
| ADS-B         | Automatic Dependent Surveillance-Broadcast           |
| ANS           | Air navigation services                              |
| ANSPs         | Air Navigation Service Providers                     |
| ATM           | Air traffic management                               |
| ATM & UA Bill | Air Traffic Management and Unmanned Aircraft Bill    |
| ATS           | Air traffic services                                 |
| CAA           | Civil Aviation Authority                             |
| CAAPS         | Civil Aviation Authority Pension Scheme              |
| Capex         | capital expenditure                                  |
| CCWG          | Customer Consultation Working Group                  |
| CMA           | Competition and Markets Authority                    |
| Commission    | European Commission                                  |
| DB            | defined benefit                                      |
| DC            | defined contributions                                |
| DC            | Determined cost                                      |
| DIWE          | Demonstrably inefficient and/or wasteful expenditure |
| DUC           | Determined unit cost                                 |
| EU            | European Union                                       |
| IBP           | Initial Business Plan                                |
| ICAO          | International Civil Aviation Organisation            |
| IPCR          | Independent Planning Cost Reviewer                   |
| NATS          | National Air Traffic Services                        |
| NERL          | NATS (En Route) plc                                  |
| Opex          | operating costs                                      |
| RAB           | Regulatory Asset Base                                |
| RBP           | Revised Business Plan                                |
| RPS           | Regulatory Policy Statement                          |
| RP2           | Reference Period 2 (2015-2019)                       |
| RP3           | Reference Period 3 (2020-2024)                       |

| <b>Abbreviations</b> |                                  |
|----------------------|----------------------------------|
| SES                  | Single European Sky              |
| TA00                 | Transport Act 2000               |
| Totex                | total expenditure                |
| tPR                  | the Pensions Regulator           |
| TRS                  | Traffic Risk Sharing             |
| WACC                 | Weighted average cost of capital |

## APPENDIX B

## CAA duties

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B1 Our duties in respect of air traffic services are set out in section 2 of the Transport Act 2000, which is reproduced below.

### 2. CAA's general duty.

- (1) The CAA must exercise its functions under this Chapter so as to maintain a high standard of safety in the provision of air traffic services; and that duty is to have priority over the application of subsections (2) to (5).
- (2) The CAA must exercise its functions under this Chapter in the manner it thinks best calculated—
  - (a) to further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them;
  - (b) to promote efficiency and economy on the part of licence holders;
  - (c) to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences;
  - (d) to take account of any international obligations of the United Kingdom notified to the CAA by the Secretary of State (whatever the time or purpose of the notification);
  - (e) to take account of any guidance on environmental objectives given to the CAA by the Secretary of State after the coming into force of this section.
- (3) The only interests to be considered under subsection (2)(a) are interests regarding the range, availability, continuity, cost and quality of air traffic services.
- (4) The reference in subsection (2)(a) to furthering interests includes a reference to furthering them (where the CAA thinks it appropriate) by promoting competition in the provision of air traffic services.
- (5) If in a particular case there is a conflict in the application of the provisions of subsections (2) to (4), in relation to that case the CAA must apply them in the manner it thinks is reasonable having regard to them as a whole.
- (6) The CAA must exercise its functions under this Chapter so as to impose on licence holders the minimum restrictions which are consistent with the exercise of those functions.
- (7) Section 4 of the Civil Aviation Act 1982 (CAA's general objectives) does not apply in relation to the performance by the CAA of its functions under this Chapter.

## APPENDIX C

# Regulatory policy statement – Policy principles relating to NERL defined benefit pension scheme costs

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## Introduction

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- C1 NATS (En Route) plc (NERL) holds an economic licence issued under the Transport Act 2000 to provide en route air traffic services in the UK (the Licence). On 29 August 2019, we published our decision (RP3 Decision) setting out proposed modifications to NERL's licence for the economic regulation of NERL during the period 2020 to 2024 (RP3). Our RP3 Decision included a statement of our support in principle to NERL's request, set out in its RP3 business plan,<sup>12</sup> for a regulatory policy statement (RPS) pertaining to pension costs.<sup>13</sup>
- C2 NERL rejected the proposed Licence modifications in our RP3 Decision and on 19 November 2019 we made a reference to the Competition and Markets Authority (CMA) to investigate and report on the proposed modifications.
- C3 In its provisional findings, the CMA supported the intended development of an RPS and considered that this would be an opportunity for us to provide further clarification on the pension pass-through mechanism.
- C4 On 23 July 2020, the CMA made its final report on the reference. The CMA recommended that we should provide improved guidance to clarify the pass-through provisions that apply, showing circumstances when determinations of future costs would and would not be subject to pass through.<sup>14</sup>

## Background

- C5 The CAA Pension Scheme (CAAPS) was split into two separately governed sections on NATS separation from the CAA: one for CAA members; and one for NATS Group members (the NATS Section). The NATS Section is a Defined Benefit pensions scheme (DB Pension Scheme), which was closed to new NATS employees from 2009, but allows existing members to continue to accrue benefits. A Defined Contribution (DC) pension scheme was introduced for new NATS employees from 2009.

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<sup>12</sup> CAA RP3 Decision, Appendix O

<sup>13</sup> CAA RP3 Decision, paragraph 5.78

<sup>14</sup> CMA Final Report, paragraph 11.35

- C6 Pension costs are a key component of NERL’s cost base, and allowances for reasonable and efficient pension costs are included in NERL’s determined costs for each regulatory period.
- C7 Generally, NERL has borne the risk – and opportunity – where there are differences between the allowances for operating costs assumed in setting its price controls and the actual costs it incurs, thereby creating a strong incentive on NERL to outperform its price control determination. However, in respect of DB pension costs, there is an exception where any difference between determined and actual costs are recovered from – or repaid to – users. This is because the underlying causes of these differences are generally accepted to be beyond NERL’s reasonable control (unforeseen and significant changes in DB pension costs resulting from unforeseeable changes in national pensions law, pensions accounting law or unforeseeable changes in financial market conditions and where the changes in DB pension costs are outside the control of NERL). In the case of cost increases, NERL also has to demonstrate it has taken reasonable measures to manage cost increases during the control period.<sup>15</sup>
- C8 Without this provision, it would be necessary to take account of the additional risk NERL would bear in setting its cost of capital, which could lead to higher charges for users. Making this exception in relation to DB pension costs therefore furthers users’ interests, promotes efficiency and economy on the part of NERL and also supports its financeability. This exception does not apply to NERL’s DC pension costs as these are considered to be wholly within the control of NERL.
- C9 The circumstances created by Covid-19 are relevant to the RPS on pension costs insofar as there is the scope for significantly greater pressure on the affordability of NERL’s charges to users. In these exceptional and difficult circumstances, all stakeholders should be prepared to play a part in helping deal with these difficulties. We expect NERL to work with its pension trustee and to take the necessary steps to ensure that the level of NERL’s pension costs remain efficient and reasonable. This recognises the important role of the pension trustee in working with NERL to achieve efficient and reasonable costs, while recognising the legal requirements on pension trustees to scheme members. By this, we mean that users will not be expected to fund Pension Costs that are inefficient or unreasonable and that Pension Costs should be consistent with our aim that overall regulated user charges are affordable.

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<sup>15</sup> As appropriate, our domestic framework for the regulation of NERL will take into account the UK’s obligations as a member of Eurocontrol. Our approach to pension pass-through provisions is consistent with the Eurocontrol ‘Principles for establishing the cost-base for en route charges and the calculation of unit rates’, Paragraph 3.3.4.2(c).

- C10 Bearing the above in mind, the purpose of this RPS is to provide guidance to NERL and the Trustee of the NATS Section of the CAAPS, on the principles to be applied in determining the level of DB Pension Scheme pension costs (the Pension Costs) that we will use to inform our decisions on NERL's price controls and in relation to the recovery of any significant and unforeseen changes to the Pension Costs by way of the pass-through mechanism discussed above.
- C11 In considering the application of this RPS, it is important that NERL is able to demonstrate how it has worked with its pension trustee and taken actions that align with, and drive, consumer benefit both now and in the future.

## Regulatory policy statement

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This RPS sets out the principles which we expect NERL and/or the Trustee of the NATS Section of the Civil Aviation Authority Pension Scheme (the NATS Section) and/or the CAA to apply in relation to the Pension Costs.

### Section 1: Principles to be applied by NERL and/or the Trustee of the NATS Section (the Trustee)

#### Principle 1: efficient Pension Costs

1. Airspace users should only pay for Pension Costs that are reasonable, efficiently incurred and reflective of actual market conditions. Airspace users should not pay for Pension Costs that are excessive or avoidable by efficient management and/or reasonable Trustee action.
2. We acknowledge the Trustee is not subject to economic regulation by the CAA and is governed by separate pensions legislation and regulated by the Pensions Regulator (tPR). Notwithstanding this, we expect to see evidence of good stewardship of the DB Pension Scheme to ensure that airspace users do not bear costs from a material failure in stewardship. The CAA expects the Trustee to operate the DB Pension Scheme in accordance with all relevant legislation, regulations, guidance from tPR and industry best practice standards of governance.
3. We expect NERL to behave in a manner consistent with a commercially minded company by taking all steps available to it which are within its legal discretion and which are in the interests of airspace users. We expect NERL to work with the Trustee and take appropriate actions to mitigate and to manage properly the Pension Cost burden on airspace users, both now and in the future.
4. We expect NERL, in working with the Trustee, to provide evidence to demonstrate that they have done all they reasonably can to mitigate the burden on airspace users arising from its pension obligations and that they have taken steps to ensure that the level of NERL's pension costs remain efficient and reasonable. This means that users will not be expected to fund Pension Costs

that are inefficient or unreasonable and that Pension Costs should be consistent with our aim that overall regulated user charges are affordable.

### **Principle 2: appropriate actuarial valuations**

5. Pension Costs should be assessed by the Trustee using actuarial methods, on the basis of reasonable and prudent assumptions in line with national law and current best practice, taking into account the strength of the employer's covenant and reflecting our commitment to fund reasonable and efficiently incurred Pension Costs.
6. We expect the level of the DB Pension Scheme funding to be assessed on the basis of forward-looking prudent assumptions regarding long-run investment returns and other key variables by appropriately appointed actuaries.
7. In the case of a pension deficit being confirmed at any formal full actuarial review, such deficit should be funded over a reasonable period thereafter, taking into account the strength of the employer's covenant, our commitment to fund reasonable and efficiently incurred Pension Costs and prevailing guidance from tPR.
8. We expect NERL to provide evidence of benchmarking of the Trustee valuation assumptions against those adopted by trustees operating schemes in sectors of the economy open to normal commercial and competitive pressures.

### **Principle 3: good stewardship**

9. We expect NERL to play an active role in ensuring the good and effective governance of the DB Pension Scheme.
10. When establishing the allowances for Pension Costs we may seek independent actuarial advice on NERL's projections for the relevant control period. We will also have regard to the assumptions supporting NERL's projections, including the outcome of any recent Trustee valuations of the DB Pension Scheme, and the stewardship of the DB Pension Scheme.

### **Principle 4: long-term funding and investment strategy**

11. In considering the long-term funding objective of the DB Pension Scheme, and the investment strategy required to deliver this, we expect the Trustees to take into account the strength of the employer's covenant including the reliance that can be placed on the stability of the framework for economic regulation.
12. Although DB pension liabilities represent a fixed obligation, the DB Pension Scheme valuation is subject to change caused by exogenous factors, including for example changes in the value of stock markets, real interest rates, or changes in longevity assumptions. Some of these factors can be managed through the investment strategy adopted by the Trustee. There is a balance to be struck between taking higher levels of investment risk with the aim that the

additional returns expected will result in lower ultimate Pension Costs and taking too much investment risk which could lead to a more volatile funding position and potentially higher deficit contributions.

13. As the DB Pension Scheme is closed to new members, there is an expectation that the DB Pension Scheme will mature relatively quickly, as active members retire or leave the DB Pension Scheme (either through leaving employment or taking the pension cash alternative). As the DB Pension Scheme matures further, it is our understanding that the Trustee will want to invest in assets to generate income and cash flows which are expected to match the benefit payments to pensioners.
14. There are various investment strategies which could achieve this and we expect that the cost implications for NERL's contributions are appropriately taken into account when deciding on the strategy.

#### **Principle 5: de-risking and treatment of surpluses**

15. As referred to above, as the DB Pension Scheme matures we expect that an increasingly risk reducing investment strategy will be developed. This could involve rebalancing from riskier to less risky assets, employing and/or increasing hedging, buy-ins, buyouts and other risk-reducing approaches. In considering these options and the pace of de-risking, we would expect NERL, in working with the Trustee, to take account of the relevant costs and consumer benefits both now and in the future, taking advice from experts as appropriate.
16. Given the regulatory assurance that this RPS is intended to provide (i.e. that DB Pension Scheme costs will be remunerated subject to the conditions this RPS contains), we would expect consideration to be given to applying any emerging surplus both to de-risking and to lowering NERL's pension contributions to reduce the burden on airspace users who are funding the DB Pension Scheme when it is in deficit.
17. In the event of a surplus being recognised at a future actuarial valuation:
  - i. in relation to deficit repair contributions, we expect these to no longer be required and, as a result, we expect airspace users to benefit from such a situation through lower charges set at the next price control or during the price control period through the pension cost pass through mechanism; and
  - ii. in relation to the surplus, we expect NERL, in working with the Trustee, to manage the surplus effectively and efficiently in the best interests of current and future airspace users.

18. In circumstances where there is a surplus, we note that Rule 10 of the DB Pension Scheme rules<sup>16</sup> allows the employer (NERL) to make arrangements for the reduction or elimination of the surplus. We expect NERL to consult with the Trustee to decide the best way to manage such surplus (whether that is to de-risk the investment strategy, to reduce employer contributions, to pursue another course of action or to pursue a combination of several courses of action). We expect NERL to provide us with information on its preferred course of action, in particular to demonstrate how the interests of airspace users have been properly taken into account in selecting the way forward.
19. The DB Pension Scheme should be managed in a way such that the risk of any trapped surplus (a surplus that cannot be resolved through contribution holidays) is remote. We expect the Trustee and NERL to minimise the likelihood of any trapped surplus arising, which is likely to be achieved by a measured and balanced approach to de-risking alongside reduced contributions. We expect NERL, in working with the Trustee, to provide evidence on how they intend to minimise such risk, in particular any provisions (such as alternative funding options) in place to ensure that any surplus can be accessed and returned to the airspace users.

## Section 2: Principles we propose to apply

### Principle 6: Remuneration of future service cost and deficit repair contributions

20. We recognise that the funding of its pension liabilities is a legal obligation on NERL and hence a necessary cost of its operations. We also recognise that allowances for reasonable and efficiently incurred Pension Costs should be fully reflected in its pricing.
21. We acknowledge that Pension Costs projected for each control period are only estimates of the actual cost and will vary over time for various reasons, including for reasons outside NERL's control. As such, it is possible that the Pension Costs reflected in NERL's pricing will also need to vary over time.
22. Subject to NERL and/or the Trustee fulfilling their obligations and complying with the principles set out in this RPS, we commit to the continued full funding of reasonable and efficient future service costs and reasonable and efficient deficit repair contributions associated with NERL's Pension Costs by way of revenue allowances in relevant control periods.
23. Our funding commitment and the principles in this RPS do not cover any element of the Pension Costs that are attributable to the activities of other entities within the NATS group which are outside the scope of NERL's Licence.

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<sup>16</sup> Civil Aviation Authority Pension Scheme Trust Deed and Rules, NATS Section, Appendix 3 (NATS Rules), Section Part 1 – Administrative Provisions, Rule 10.2

**Principle 7: Pass through mechanism in relation to unforeseen and significant changes in the Pension Costs**

24. The statutory regime which governs the funding of DB pension schemes requires actuarial valuations to be performed at least every three years. These triennial valuations have not generally aligned with the control periods (or reference periods under the EU Performance Scheme). While the duration of the UK's regulatory periods are not yet determined following its withdrawal from the EU, we note the requirement in the Eurocontrol Principles that reference periods cover a minimum of three years and a maximum of five years. As a result, the level of cash contributions that NERL is required to make to the DB Pension Scheme may vary from the allowances assumed in the performance plan/price control.
25. Pass-through is the regulatory mechanism that allows for any significant and unforeseen changes to the Pension Costs included in the performance plan/price control to be recovered from – or repaid to – to airspace users through NERL's prices.
26. Pass-through is permitted where the following criteria are satisfied:<sup>17</sup>
- i. the pension costs have been established and specified in the determined costs;
  - ii. there are unforeseen and significant changes in those pension costs;
  - iii. the changes result from unforeseeable changes in national pensions law, pensions accounting law or unforeseeable changes in financial market conditions;
  - iv. the changes in the pension costs are outside NERL's control; and
  - v. NERL has taken reasonable measures to manage the increase in pension costs.
27. We envisage that “*unforeseen and significant changes*” to Pension Costs efficiently incurred by NERL, which have arisen from “*unforeseeable changes*” in the laws and market conditions noted in sub-paragraph iii) above, would be eligible for the Pension Cost pass-through.
28. Whether a change is “unforeseeable” or “unforeseen”, as appropriate, will need to be considered on a case-by-case basis and will depend on the circumstances at the relevant time. By way of demonstration of how we envisaged applying these terms, during the CMA reference of the RP3 price controls we provided

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<sup>17</sup> Paragraph 3.3.4.2(c) of the Eurocontrol Principles.

two examples of circumstances when we thought determinations of future costs would and would not be subject to pass-through:

- if the financial market returns and therefore required DB deficit costs at the 2020 valuation were in line with NERL's business plan costs, then the £18 million reduction we made to NERL's forecast costs at RP3 would be eligible to be funded through the pension cost pass-through, subject to checks that the costs are efficient and take account of offsetting cost savings that NERL has made. This follows from items (iii), (iv) and (v) at paragraph 26 above as the financial market conditions at the next pensions valuation are unforeseeable and outside NERL's control, and NERL needs to demonstrate it has taken reasonable measures to manage the increase in pension costs; and
- increases in costs that arise due to salaries and staff levels, for example, would not be eligible for pass-through as they are, in our view, "controllable" under item (iv) in paragraph 26 above.

### **Principle 8: stability of regulatory regime**

29. The stability of the regulatory framework over the long term should provide the Trustee with greater confidence in NERL's ability to meet its legal obligations to support the DB Pension Scheme. For airspace users who bear these costs, this ensures appropriate levels of contributions through an efficient long-term funding objective and investment approach which retain an appropriate level of risk and return.
30. Assuming that NERL and the Trustee fulfil their obligations and subject to any changes in legislation, we commit to maintaining principles 6 and 7 above for the foreseeable future. We propose that any changes to this policy would be subject to consultation with stakeholders, including airspace users, NERL and the Trustee.
31. Due to the unknown nature of any changes that may be made in the future and to maintain regulatory discretion, we have not sought to include a specific notice period in this RPS for when such changes should come into effect. We therefore propose that any consultation mentioned in paragraph 30 above should include proposals on the appropriate notice period for implementing any new arrangements or principles (save in respect of any changes required by law). Our expectation, however, is that this policy should apply for more than one price control period, in order to provide greater certainty to NERL on the principles we will use to inform our decisions on NERL's price controls.