

NATS (EN ROUTE) PLC REGULATORY ACCOUNTING GUIDELINES

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Note

The present issue, Issue 4, of the Regulatory Accounting Guidelines reflects the adoption of a historic cost accounting basis for the segmental accounting sections of the regulatory accounts.

1 Introduction

- 1.1 These Guidelines set out the requirements for the preparation of the regulatory accounts which NATS (En Route) plc ("NERL") is required to maintain by virtue of Condition 6.4 of its Licence issued pursuant to the Transport Act 2000 (the "Licence"). These Guidelines may be amended from time to time, in consultation with and with the approval of the Civil Aviation Authority ("CAA"), in order to reflect business and regulatory requirements and best practice.

2 Objectives of the Regulatory Accounts

- 2.1 The purpose of the regulatory accounts is to make available such regulatory accounting information as will:
- (a) enable the CAA and the public to assess the financial position of NERL and the financial performance of each Separate Business on a consistent basis, distinct from each other and any other business of NERL and its affiliate or related undertakings;
 - (b) assist the CAA to assess NERL's compliance with the Licence in respect of the financial relationship between NERL and its affiliate or related undertakings;
 - (c) assist the CAA to monitor performance against the assumptions underlying the current price control; and
 - (d) inform future price control reviews.

3 Accounting Periods

- 3.1 The financial year for the regulatory accounts will be the same as for the statutory accounts (currently 1 April to 31 March).

4 Format and content of the regulatory accounts

- 4.1 Regulatory accounting statements will be prepared showing the amounts for NERL and the amounts attributable to each of the two segments defined below:
- UK Air Traffic Services (UKATS) which comprises the En route (UK) Business as defined in the Licence (see Annex 1), the contract with the Ministry of Defence and the Other Services provided by NERL. The En route (UK) Business constitutes one of the Separate Businesses specified by the Licence. The UKATS grouping is adopted for the regulatory accounts because it constitutes the Single Till which formed the basis on which the charge condition for the control of Eurocontrol charges was assessed for the first five years.
 - The En route (Oceanic) Business ("Oceanic").

These segments are also used for the purposes of tracking the regulatory asset base and regulatory performance measured on the regulatory basis.

This structure is illustrated in Annex 2.

- 4.2 The regulatory accounts will include for NERL:
- A profit and loss account including interest and tax.
 - A statement of capital employed, reconciled to the statutory balance sheet.
 - A cash flow statement.
- 4.3 The regulatory accounts will include for each of the two segments (UK Air Traffic Services and Oceanic):
- A profit and loss account to the level of profit before interest and tax (PBIT).
 - A statement of capital employed, excluding funding and tax balances.
 - An operating cash flow analysis.
- 4.4 These segmental accounting results will be presented on a historic cost basis, the same basis as in the statutory accounts.
- 4.5 The intangible asset and its associated amortisation that appear in the statutory accounts of NERL as a result of the PPP transaction are not included in the regulatory accounts because they have not been recognised for the purposes of economic regulation.
- 4.6 A reconciliation between the regulatory accounts and the statutory accounts for NERL will be included.
- 4.7 The regulatory accounts will include:
- a record of the movement in the regulatory asset base, calculated in accordance with the basis used to set the price control for the quinquennium;
 - a comparison of performance with the regulatory assumptions;
 - a record of the incremental out-performance for the purpose of the operating cost efficiency roll forward (section 5 of Annex 4 of the CAA Decision); and
 - a record of the actual and benchmark cash flows for the purpose of the RAB clawback (section 6 of Annex 4 of the CAA Decision).
 - a record of the RPI indices used to convert between price bases in these statements.
- 4.8 Proforma regulatory accounts are shown in Annex 3. The formulae for use in the statements tracking the regulatory asset base are set out in Annex 4.
- 4.9 The regulatory accounts will include a financial commentary. This will supplement the operating and financial reviews in the NATS group and/or NERL accounts. The analysis will comment on the segmental results, on actual performance (revenues, costs and the return) compared with the regulatory determination, and on the tracking of the regulatory asset base.
- 4.10 The notes to the regulatory accounts will explain the basis of the regulatory accounts where this varies from the statutory accounts. Notes to the accounts already included in the statutory accounts for NERL need not be duplicated.

5 Basis of Preparation

- 5.1 Except in so far as stated in these Guidelines in order to meet the purposes of the regulatory accounts, the regulatory accounts will be prepared in accordance with accounting principles generally accepted from time to time in the United Kingdom.
- 5.2 The regulatory accounts will be derived from the accounting records which NERL is required to keep by the Companies Acts. These accounting records will be kept in such a form as is necessary to enable NERL to comply with Condition 6 of the Licence and these Regulatory Accounting Guidelines.

6 Allocations and Apportionments

- 6.1 The basis on which any amount has been either:
- charged from or to any other business of NERL (whether or not a Separate Business) together with a description of the basis of that charge; or
 - determined by apportionment or allocation between any Separate Business and any other business of NERL (whether or not a Separate Business),

will be determined in accordance with the principles set out in Annex 5.

7 Auditors' report and provision of information to the CAA

- 7.1 NERL will procure a report by the Auditors addressed to the CAA stating whether in their opinion the regulatory accounts for the financial year have been properly prepared in accordance with these Regulatory Accounting Guidelines and on that basis fairly present the financial performance of NERL, analysed between each separate segment as defined in these Guidelines, and the financial position of NERL.

8 Publication of the Regulatory Accounts

- 8.1 NERL will arrange for copies of the regulatory accounts and the Auditors' report to be made publicly available and, unless not reasonably practicable, to do so when the annual statutory accounts of NERL are made available.

ANNEX 1 **DEFINITIONS FROM THE LICENCE**

Separate Business: means each of the En route (UK) Business and the En route (Oceanic) Business, taken separately from one another and from any other business of NERL, but so that where all or any part of such business is carried on by an affiliate or related undertaking of NERL such part of the business as is carried on by that affiliate or related undertaking shall be consolidated with any such business of NERL (and of any other affiliate or related undertaking) so as to form a single Separate Business.

En route (UK) Business: means NERL's business which consists of the provision by NERL of the UK En route Air Traffic Control Service, the Advisory Control Service, the Terminal Approach Service and the Specified Services.

En route (Oceanic) Business: means NERL's business which consists of the provision by NERL of the Oceanic En route Air Traffic Control Service.

UK En route Air Traffic Control Service: means an Air Traffic Control Service in respect of the En route (UK) Area other than any Airfield Service or the Terminal Approach Service.

Advisory Control Service: means the giving of instructions or advice to aircraft flying on those advisory routes and areas described in the AIP to the extent undertaken by NERL as at the date of the coming into effect of this Licence:

- (a) for the purpose of preventing, or assisting in the prevention of, collisions between aircraft; and
- (b) with a view to facilitating the flow of air traffic for the purpose of expediting and maintaining an orderly flow of air traffic where appropriate in consultation with the CAA or any other provider of air traffic services or any international body responsible for co-ordinating air traffic services.

Terminal Approach Service: means, in respect of Heathrow, Gatwick and Stansted airports, the Airfield Service other than such element of service as is provided to an aircraft on its final approach path or initial departure path or on the manoeuvring area or apron of the aerodrome.¹

Specified Services: means the services set out in Schedule 4 of the Licence: aeronautical messaging network, air traffic operational telephone network, emergency fixing facility, emergency frequency facility, navigational infrastructure services, the North Sea helicopter advisory service, nuclear and chemical accident service, surveillance infrastructure services, UK aeronautical information service, UK flight information service and the UK meteorological information service.

Affiliate: in relation to NERL, means any holding company of NERL, any subsidiary of NERL or any subsidiary of a holding company of NERL.

¹ This service is generally referred to as the London Terminal Approach.

ANNEX 2 **NERL SEGMENTS FOR THE PURPOSES OF THE REGULATORY ACCOUNTS**

The diagram below explains the terms used in the Regulatory Accounting Guidelines.

NERL					
UK Air Traffic Services					Oceanic
Eurocontrol	MoD Contract	London Terminal Approach	North Sea Helicopters	Other Services (Note 3)	

Notes

1. UK Air Traffic Services (UKATS) as defined above provided the basis (the single till) for the price control in the first quinquennium.
2. Three elements of UKATS - Eurocontrol, London Terminal Approach (the approach services for Heathrow, Gatwick and Stansted) and North Sea Helicopters - comprise the En Route (UK) Business (the Separate Business) as defined by the Licence. The Ministry of Defence contract and the Other Services are permitted businesses as defined in Condition 5, paragraph 12 of the Licence.
3. Other Services consists of:
 - (a) Cross Charges to NATS (Services) Ltd., which represent the trading from NERL to NATS (Services) Ltd., which comprises an airports division and a business development division.
 - (b) External turnover from other services, which must not exceed 3% of the aggregate turnover of the En Route (UK) and En Route (Oceanic) Businesses (NERL Licence, Condition 5, paragraph 12 (a) (v)).
4. UKATS and Oceanic are used both for the segmental reporting and for the record of the movement in the regulatory asset base and the comparison of performance with the regulatory assumption.

ANNEX 3: PROFORMA NERL REGULATORY ACCOUNTS

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1. RESPONSIBILITIES IN RESPECT OF THE PREPARATION OF THE REGULATORY ACCOUNTS

Statement of the regulatory accounting responsibilities of the Directors of NERL, under Condition 6 of the Licence and the Regulatory Accounting Guidelines.

2. PURPOSE AND BASIS OF PREPARATION

Statement of the purpose of the regulatory accounts and of the basis of preparation, including the basis of cross charges, allocations and apportionments.

3. FINANCIAL COMMENTARY

The regulatory accounts will include a discussion and interpretation of the financial performance of the business in the context of the regulatory settlement. This will supplement the operating and financial reviews in the NATS group and/or NERL statutory accounts. The analysis will comment on:

- the segmental results (sections 4-6);
- the tracking of the regulatory asset base, including an explanation of the differences between the regulator's assumptions and the outturn (section 7); and
- performance (revenues, costs and the return) compared with the regulatory determination (section 8).

4. INDEPENDENT AUDITORS' REPORT TO THE CAA AND THE DIRECTORS OF NATS (EN ROUTE) PLC.

5. PROFIT AND LOSS ACCOUNT

£m Year ended 31 March	UKATS		Oceanic		NERL	
	Year	Prior year	Year	Prior year	Year	Prior year
<u>Turnover</u>						
External						
Intra group						
Total						
<u>Operating Costs</u>						
People costs						
Services and materials						
Repairs and maintenance						
External research and development						
Other operating charges						
Depreciation						
Capitalisation of internal costs						
Intra group allocated charges						
Total net operating costs						
Profit before interest and tax						
	Interest					
	Profit after interest but before tax					
	Tax					
	Profit after interest and tax					

Explanatory Notes

1. Fixed asset depreciation to be stated net of grants and other contributions.

Analysis of intra-group allocated charges

£m	<u>Allocated from NATS and NSL to NERL</u>		
	UK Air Traffic Services	Oceanic	Total
<u>Operating costs allocated</u>			
People costs			
Services and materials			
Repairs and maintenance			
External research and development			
Other operating and general			
Depreciation			
Capitalisation of internal costs			
Total			

Reconciliation to profit/(loss) after interest and tax in the NERL statutory accounts

£m	Regulatory accounts	add: amortisation of goodwill	Any further reconciling items	NERL Annual Report and Accounts
Turnover				
UK Air Traffic Services				
Oceanic				
Total				
Net operating costs				
Any other items				
Profit/(loss) on ordinary activities before interest				
		Net interest payable and similar charges		
		Profit/(loss) before taxation		
		Tax		
		Profit/(loss) for the financial period transferred to/from reserves		

6. BALANCE SHEET AND SEGMENTAL CAPITAL EMPLOYED STATEMENTS

£m Year ended 31 March	UKATS		Oceanic		NERL.	
	Year	Prior year	Year	Prior year	Year	Prior year
Tangible fixed assets (Note 1)						
Current assets						
less: Current liabilities						
Provisions for liabilities and charges						
Capital employed						

£m	Year	Prior year
Total NERL capital employed as above		
Intangible asset		
Inter-company debtor/creditor		
Cash		
Tax items:		
Corporation tax		
Deferred tax		
Loans		
Facility fees		
Net assets per NERL statutory accounts		

£m	Year	Prior year
Share capital		
Other reserves		
Profit and loss account		
Net assets per NERL statutory accounts		

Explanatory Notes

1. Fixed asset amounts are shown net of grants and other contributions. Movements in tangible fixed assets are set out in the note below.
2. Current assets in the statement of capital employed exclude cash, funding and tax balances.

Movements in tangible fixed assets

£m	Land	Buildings		Air traffic control systems, plant and equipment	Vehicles	Furniture, fixtures and fittings	Assets in course of construction	TOTAL
		Free-hold	Lease-hold					
Cost at 1 April								
Additions during year								
Disposals during year								
Other transfers during year								
Cost at 31 March								
Depreciation at 1 April								
Provided during year								
Disposals during year								
Impairment								
Depreciation at 31 March								
Net book value at 31 March								
Net book value at 31 March (prior year)								

This will be produced for:

- UKATS;
- Oceanic; and
- NERL in total.

The UKATS and Oceanic figures will include some apportionments.

Fixed asset reconciliation to the statutory accounts

£m	NERL	
	Year	Prior year
Year ended 31 March		
Tangible fixed assets per the regulatory accounts		
add: grants and other contributions towards fixed assets		
Tangible fixed assets per the statutory accounts		

7. CASH FLOW ANALYSIS BY SEGMENT

£m Year ended 31 March	UKATS		Oceanic		NERL	
	Year	Prior year	Year	Prior year	Year	Prior year
Profit/(loss) before interest and tax						
Depreciation						
Increase/(decrease) in impairment provision						
Loss/(profit) on sale of tangible fixed assets						
(Increase)/decrease in debtors						
Increase/(decrease) in creditors						
(Increase)/decrease in provisions						
Net cash inflow from operating activities						
Capital expenditure (Note (a))						
Net cash flow						
	Movement in intra-group indebtedness Interest and financing charges (Note (b)) Taxation: UK corporation tax Cash flow before financing Financing (Note (c)) (Decrease)/increase in cash Opening NERL cash balance Closing NERL cash balance					

Explanatory Notes

1. UKATS and Oceanic are not trading entities. The cash flow statements for these two segments are prepared from the accounting records of the company and include apportionments.

a) Capital expenditure

£m Year ended 31 March	UKATS		Oceanic		NERL	
	Year	Prior year	Year	Prior year	Year	Prior year
Purchase of tangible fixed assets (net of grants and other contributions)						
Own work capitalised						
Proceeds from sales of tangible fixed assets						
Net cash outflow from capital expenditure						

b) Interest and financing charges

£m, Year ended 31 March	Year	Prior year
Interest received		
Interest paid		
Net cash outflow from interest and financing charges		

c) Financing

£m, Year ended 31 March	Year	Prior year
New loans		
Repayment of loans		
Net cash flow from financing		

8. MOVEMENT IN THE REGULATORY ASSET BASES

Introduction

The regulatory asset base (RAB) is expected to be a key input to the determination of prices at future price reviews. The statements in sections 8.2 and 8.3 record the development of the RABs for UK Air Traffic Services and for Oceanic and compares them with the projections used by the regulator in its charge control advice to the Government. The notes in section 8.1 are for general information and explanation. The details of the definitions and the formulae are set out in Annex 4.

The specification is based on the Advice issued by the CAA to DETR in August 2000 and the CAA Decision (March 2003).

8.1 Basis of calculation

In summary (and ignoring adjustments for inflation), the closing RAB is calculated at the end of each financial year in the following way:

$$\begin{aligned} \text{Closing RAB} &= \text{Opening RAB (i.e. closing RAB at the end of the previous} \\ &\quad \text{financial year (or for the first year of the quinquennium, the} \\ &\quad \text{values given below))} \\ &+ \text{ Total net actual capital expenditure} \\ &+ \text{ Capitalised financing costs} \\ &+/- \text{ Actual movements in working capital} \\ &- \text{ ERG's assumed ordinary depreciation} \\ &- \text{ Price profiling adjustment (for the UKATS RAB only)} \end{aligned}$$

These terms are explained in the notes below.

Opening RAB

The opening RAB is normally the closing RAB from the previous year.

The initial opening RAB values at the start of the first year of Control Period 1 were set out in the CAA's Advice to DETR. Following the adjustment made in the CAA Decision, the opening UKATS RAB will be uplifted by 12% of the initial opening RAB at 31 March 2001 (£611 million at 1999/2000 prices). The opening RABs will now be (in 1999/00 prices):

- UKATS RAB at 1st April 2001= £684.32 million
- Oceanic RAB at 1st April 2001= £13 million.

The definition of capital employed used for the initial RAB at 1 April 2001 is:

Total assets less cash, current liabilities (excluding loans repayable within one year), provisions and deferred income

The amounts were derived from actual figures for 31 March 2000 and forecasts of capital expenditure and depreciation for the year to 31 March 2001.

The definition excludes any tax or interest balances, and the fixed asset amounts figures are included on an indexed basis.

Net actual capital expenditure

Capital expenditure made during a year is added to the closing RAB for that year. The figures for capital expenditure will be taken from NERL audited accounts on an accruals basis. The figures will be split between capital expenditure related to UKATS and capital expenditure related to the Oceanic business. The figure added to the RAB for capital expenditure will be net of the proceeds in respect of tangible fixed asset disposals and of any grants or contributions to fixed assets.

Capitalised financing costs

The price control set by the CAA does not include a return on all the assets in the RAB in the first quinquennium. For the assets on which a return has not been included, the financing costs are capitalised and added to the RAB, to enable NATS to recover them in future review periods.

Capitalised financing costs are calculated on the basis used to set the price control for the first Control Period, reflecting the derivation of the allowed revenue during the period. The interest rate used is the pre-tax real cost of capital as determined by the CAA (7.75% for UKATS and 8.0% for Oceanic). The actual amount of financing costs capitalised will vary depending on the actual capital expenditure made.

Actual movements in working capital

To ensure that inflation is correctly allowed for (see the note on inflation adjustments below), actual movement is derived as closing working capital (which is at year end prices) less opening working capital (uplifted to year end prices).

ERG's assumed ordinary depreciation

The depreciation figures used for rolling forward the RAB are the figures assumed when the price control was set for the first Control Period. As these figures were forecasts, they are likely to differ from the actual current cost depreciation figures reported in the main regulatory accounts.

Using the depreciation figures assumed in setting the price cap ensures that the RAB at the end of the quinquennium is consistent with the depreciation that NATS has been allowed to earn during the period.

Price Profiling Adjustment

There is a "price profiling adjustment" to the UKATS RAB. There is no such adjustment to the Oceanic RAB.

The CAA introduced the price profiling adjustment so as to profile the price charged between the present price control period (2001-5) and future price control periods. It is included in the allowed revenue of the present price control period and deducted from the RAB. Hence, it tends to raise prices in the first quinquennium in order for them to be lower in the future. The price profiling adjustment can be thought of as accelerated depreciation.

Inflation adjustments

The RAB is expressed at the price level for the year end to which it relates. Figures brought forward are uplifted to the current year end levels, using the Retail Price Index. Figures for expenditure during the year are uplifted from average to year end levels.

8.2 UKATS RAB Calculation

As at 31 March	Outturn	CAA's projection	Variance
Opening RAB as reported in previous year's prices			
<i>The figures below are all expressed in terms of the prices applicable to the date in question</i>			
Opening RAB restated at year end prices			
plus total actual capital expenditure (at year end prices)			
plus capitalised financing costs on capital expenditure not remunerated during the control period			
plus/minus actual movements in working capital (see note above)			
Minus CAA's assumed ordinary depreciation charge x RPI growth from 1999/2000			
Minus price profiling adjustment x RPI growth from 1999/2000			
Closing RAB			

Supporting notes will be developed as required.

In the above table, the figures for the CAA's projections of UKATS capital expenditure and UKATS working capital movements are as follows (in 1999/00 prices):

(£ million)	UKATS capex	UKATS movements in working capital
2001/02	138.344	14.338
2002/03	159.031	(0.027)
2003/04	128.835	4.206
2004/05	119.307	0.426
2005/06	103.914	2.213

A five year summary will be gradually built up over the period of the quinquennium, recording the total RAB as projected by the CAA and the outturn figures:-

Closing UKATS RAB

At 31 March, £ million at outturn prices	2001	2002	2003	etc.
Actual				
CAA projection				

Note: The closing UKATS RAB is stated inclusive of the 12% uplift specified in the CAA Decision, and the regulatory accounts will include a note to explain this.

8.3 Oceanic RAB Calculation

As at 31 March	Outturn	CAA's projection	Variance
Opening RAB as reported in previous year's prices			
<i>The figures below are all expressed in terms of the prices applicable to the date in question</i>			
Opening Oceanic RAB restated at year end prices			
plus total actual Oceanic capex (at year end prices)			
plus Oceanic capitalised financing costs on capital expenditure not remunerated during the control period			
plus/minus actual movements in working capital (see note above)			
minus CAA's assumed Oceanic depreciation charge x RPI growth from 1999/2000			
Closing Oceanic RAB			

Supporting notes will be developed as required.

In the above table, the figures for the CAA's projections of Oceanic capital expenditure and single till working capital movements are as follows (in 1999/00 prices):

(£ million)	Oceanic capex	Oceanic movements in working capital
2001/02	4.711	(0.264)
2002/03	5.730	(0.039)
2003/04	5.518	0.009
2004/05	4.566	0.232
2005/06	2.005	0.358

A five year summary will be gradually built up over the period of the quinquennium, recording the total RAB as projected by the CAA and the outturn figures:-.

Closing Oceanic RAB

At 31 March, £ million at outturn prices	2001	2002	2003	etc.
Actual				
CAA projection				

8.4 Reconciliation between RAB and capital employed per regulatory accounts

To explain the differences between the closing regulatory asset base and the capital employed figures shown in the segmental accounts.

Reconciliation

UKATS closing capital employed (taken from the capital employed statement of the regulatory accounts (section 5))

+/- difference between opening RAB and opening current cost capital employed

+/- ERG's assumed ordinary depreciation less depreciation per the regulatory accounts

+/- price profiling adjustment

+/- capitalised financing costs

+/- any other adjustments

= UKATS RAB.

A similar reconciliation will be presented for the Oceanic segment.

9. COMPARISON OF PERFORMANCE WITH THE REGULATORY ASSUMPTIONS

Sections 9.1 and 9.2 present the performance of the regulated businesses, measured on the same basis as used in the CAA's charge control Advice to DETR in August 2000. They show the actual performance, that assumed by the CAA in its charge control Advice and the variance between them. Performance is analysed separately for UKATS, and the Oceanic business. Section 9.3 records the performance on the operating cost efficiency roll forward for each of UKATS and Oceanic. Section 9.4 records the NERL cash flows compared with the benchmark cash flows for the purpose of the potential clawback of the UKATS RAB uplift.

9.1 Performance of UKATS compared to the CAA's projections

(All shown in average prices for the financial year concerned (Note 1))

(Year ended 31 March - £ million)	Actual	CAA's Projection	Variance
UKATS Revenue (Note 2)			
Costs:			
- Operating costs (Note 3)			
- Depreciation assumed in price control (Note 4)			
- Price profiling adjustment (Note 5)			
Total costs			
Regulatory profit (Note 6)			
Deferred return (consisting of the charge for capitalised financing costs on assets not remunerated within the price control period) (Note 7)			
Regulatory profit plus deferred return - (a)			
Average RAB - (b)			
Rate of return ((a) divided by (b)) (Note 8)			

Explanatory Notes

- The figures in the table are all shown in terms of average prices for the financial year as a whole.¹ This means that some of them (namely, the depreciation assumed in the price control, price profiling adjustment, deferred revenue/capitalised financing costs

¹ Average prices are taken to be the mean of the twelve monthly RPI figures for the financial year in question.

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and average RAB) are slightly different from the figures presented in the section recording the movement in the RAB, where they are presented in end of year prices.

2. Revenue is turnover for UKATS from the segmental profit and loss account (section 4)
3. Operating costs are UKATS operating costs from the segmental profit and loss account (at section 4), less depreciation and impairment charges and after eliminating the profit or loss on asset disposals.
4. The calculation uses the forecast of depreciation that was assumed in the price control, rather than the depreciation used in NATS regulatory accounting statements. This is because the RAB is reduced by the assumed depreciation rather than the depreciation charge included in the segmental accounting statements.
5. The price profiling adjustment is treated by the regulator as accelerated depreciation, and is deducted in the same way as other depreciation.
6. Regulatory profit differs from profit before interest and tax shown in the segmental accounts because of the different depreciation figures used and (for UKATS) the introduction of the price profiling adjustment in the above table.
7. The principle underlying this figure is that financing costs on those assets on which a return has not been included within the 2001-5 price control period are capitalised and added to the RAB to enable remuneration in future review periods. They can be thought of as a deferred return.
To ensure a fair comparison of the pre-financing return with the RAB, these financing costs must be added to the regulatory profit figure, and the total of these is then compared to the average RAB.
The detail of the derivation of the capitalised financing costs is given in the section recording the movement in the RAB.
8. The rate of return in the CAA's projection column is the allowed cost of capital.

In the above table, the figures for the CAA's projections are as shown below:

<u>CAA's Projection of UKATS Performance (£million in 1999/00 prices)</u>					
	<u>2001/2</u>	<u>2002/3</u>	<u>2003/4</u>	<u>2004/5</u>	<u>2005/6</u>
Revenue	458.344	461.308	461.673	459.995	460.677
Operating costs	(356.579)	(335.471)	(340.160)	(344.258)	(339.328)
Monetary working capital adjustment	(0.328)	(0.626)	(0.716)	(0.783)	(0.737)
Depreciation assumed in price control	(41.754)	(57.821)	(60.657)	(59.181)	(65.565)
Price profiling adjustment	(17.791)	(17.791)	(17.791)	(17.791)	(17.791)
Regulatory profit	41.894	49.600	42.350	37.983	37.257
Capitalised financing costs	9.523	12.395	20.191	29.205	36.504
Regulatory return	51.416	61.994	62.541	67.188	73.760
Average RAB	662.330	761.553	846.839	920.214	985.835

Commentary on the variances

A commentary on the variances will be included in this section or in the Financial Commentary.

The price cap set by the Government allows a higher revenue stream than the CAA's Advice. The impact of this will be discussed in the commentary.

9.2 Performance of the Oceanic business compared to the CAA's projections

(All shown in average prices for the financial year concerned)

(Year ended 31 March - £ million)	Actual	CAA's Projection	Variance
Revenue from Oceanic business			
Oceanic costs:			
- Operating costs			
- Depreciation assumed in price control			0
- Total costs			
Regulatory profit			
Deferred return (consisting of capitalised financing costs on assets not remunerated within price control period)			
Regulatory profit plus deferred return - (a)			
Average RAB - (b)			
Rate of return ((a) divided by (b))			

The above calculations are similar to the UKATS ones except that there is no price profiling adjustment for the Oceanic business. The same explanatory notes apply.

In the above table, the figures for the CAA's projections are as shown below:

<u>CAA's Projection of Oceanic Performance (£million in 1999/00 prices)</u>					
	<u>2001/2</u>	<u>2002/3</u>	<u>2003/4</u>	<u>2004/5</u>	<u>2005/6</u>
Revenue	19.441	19.857	20.151	20.502	20.688
Operating costs	(17.238)	(17.977)	(18.575)	(18.664)	(18.664)
Monetary working capital adjustment	0.006	0.012	0.014	0.012	0.005
Depreciation assumed in price control	(0.965)	(0.937)	(0.879)	(1.034)	(1.041)
Regulatory profit	1.244	0.955	0.711	0.816	0.988
Capitalised financing costs	0.291	0.579	0.962	1.319	1.558
Regulatory return	1.535	1.533	1.673	2.136	2.546
Average RAB	14.887	19.439	24.910	30.256	34.238

Commentary on the variances

A commentary on the variances will be included in this section or in the Financial Commentary.

9.3 Operating cost efficiency roll-forward

(£ million, 2001/02 prices)	2002/03	2003/04	2004/05
<u>UKATS</u>			
<u>Current year:</u>			
Operating expenditure assumed by CAA			
Actual operating expenditure			
Out-performance (A)			
<u>Previous year:</u>			
Operating expenditure assumed by CAA			
Actual operating expenditure			
Out-performance (B)			
Incremental out-performance (A-B)			
<u>Oceanic</u>			
<u>Current year:</u>			
Operating expenditure assumed by CAA			
Actual operating expenditure			
Out-performance (A)			
<u>Previous year:</u>			
Operating expenditure assumed by CAA			
Actual operating expenditure			
Out-performance (B)			
Incremental out-performance (A-B)			

9.4 Record of cash flows for the purpose of the clawback of the UKATS RAB uplift

The CAA Decision states (para 6.29) that to the extent that NERL's actual cash flows exceed a benchmark, the UKATS RAB in 2011 will be reduced by a proportion (40%) of the out-performance. In real NPV terms, the clawback will not exceed the 12% uplift. The CAA expects NATS' published regulatory accounts explicitly to record progress of this on a year-by-year basis. The mechanism is set out in Annex 4, section 6.

The calculation includes:

- The starting value of the UKATS plus Oceanic RABs in 2003/04, which counts as a negative cash flow contribution.
- The difference between the actual cash flows and 80% of the benchmark cash flows in each year 2003/04 to 2009/10.
- The closing value of the UKATS plus Oceanic RABs in 2009/10, which counts as a positive cash flow contribution.

All values are stated in 2001/02 prices and discounted back to the beginning of 2001/02, using the regulatory cost of capital (i.e. 7.75% for the years in CP1 and the CP2 regulatory cost of capital for the years 2006/7 onwards).

To record the progress year by year, the regulatory accounts will record:

- NERL's actual cash flows in outturn and 2001/02 prices.
- The benchmark cash flows for the year concerned.
- The discounted values, at 2001/02 prices, that will be incorporated into the calculation to be performed in 2011/12.
- The record will be built up year by year.

(£ million)	2003/04	etc.
ACTUAL FIGURES IN OUTTURN AND 2001/02 PRICES		
NERL operating cash flow from cash flow statement		
less: NERL capital expenditure from cash flow statement		
Total NERL actual cash flow in outturn (mid year) prices		
Total NERL actual cash flow in average 2001/02 prices		
Actual closing 2002/03 UKATS + Oceanic RABs		
- in outturn (year end) prices		
- in average 2001/02 prices		
RECORD OF THE DISCOUNTED VALUES		
	2003/04	2004/05
Benchmark figures		
<u>RAB</u>		
Opening RAB (as stated in the CAA Decision in 2001/02 prices, discounted to the beginning of 2001/02)	618.2	
<u>Cash flows</u>		
Benchmark cash flows in average 2001/02 prices	91.6	
Discount factor for year, back to beginning of 2001/02	1.2043	
Benchmark cash flow discounted to April 2001	76.061	
80% of the discounted amount	60.849	
Actuals		
<u>RAB</u>		
Opening RAB at 1 April 2003 in average 2001/02 prices		
Discount factor (1.0775 ²)	1.1610	
Opening RAB at 1 April 2003 in average 2001/02 prices discounted back to the beginning of 2001/02		
<u>Cash flows</u>		
Actual cash flows in average 2001/02 prices		
Discount factor for year, back to beginning of 2001/02	1.2043	
Actual cash flow discounted to April 2001		

Annex: Record of the Retail Price Indices used in the regulatory calculations.

	1999/2000	2000/01	2001/02	2002/03	etc.
Average for year/mid year	166.4	171.3	173.9	177.5	
At 31 March (year end)		172.2	174.5	179.9	

ANNEX 4: FORMULAE FOR TRACKING THE REGULATORY ASSET BASE

Note: this annex is a copy of Annex 4 from "NATS' Application to re-open the Eurocontrol Charge Control - CAA Decision" (March 2003).

1. Introduction

This Annex summarises the detail of the formulae which will govern the tracking the regulatory asset base. The purpose of this annex is to describe how to calculate the Regulatory Asset Bases (RABs) for:

- UKATS; and
- Oceanic.

The Annex comprises the following sections:

- *Section 2*: sets out the approach to inflation which is to be incorporated when calculating the RAB;
- *Section 3*: establishes the UKATS RAB, the application of a RAB uplift and the approach for rolling the RAB forward;
- *Section 4*: establishes the Oceanic RAB and the approach to be employed in rolling it forward;
- *Section 5*: summarises the approach to be taken in calculating the operating cost efficiency roll-forward mechanism and applying any out/underperformance to the RAB; and
- *Section 6*: summarises the approach to be employed in 'clawing back' the UKATS RAB uplift, if NERL's performance exceeds a specified level.

The policies set out in this Annex are based on the advice issued by the CAA to DETR in August 2000. There are however several exceptions to this:

- The calculation of the UKATS RAB (Section 3.1 below) now incorporates a 12% uplift;
- Those equations contained within Section 5 (operating cost efficiency roll forward mechanism); and
- Those in Section 6 (RAB clawback mechanism)

If NERL were to change its financial year from 1st April to 31st March, the following equations (including the "fixed" amounts quoted in them) would need to be adjusted.

2 Inflation indices

Each year, the RAB is expressed in actual end year price levels. The ERG modelling uses fixed 1999/2000 price levels and these figures must be uplifted to out-turn price terms each year. The price basis is to be adjusted as follows.

Retail Price Index ("RPI") Growth $_t$ from 1999/2000 = The RPI (as defined in the Licence) at the end of the financial year $_t$
divided by
the average of the monthly RPI figures for the financial year 1999/2000 which, based on the All Items index² equals 166.4. (The origin of the index is 13 January 1987=100)

Annual RPI Growth $_t$ = The RPI at the end of the financial year $_t$
divided by
The RPI at the end of the financial year $_{t-1}$

Within year RPI Growth $_t$ = The RPI at the end of the financial year $_t$
divided by
the average of the monthly RPI figures for the financial year $_t$

RPI Growth from 2001/2 $_t$ = The RPI at the end of the financial year $_t$
divided by
the average of the monthly RPI figures for the financial year 2001/2 which, based on the All Items index equals 173.9. (The origin of the index is 13 January 1987=100)

Mid year deflator to 2001/2 prices $_t$ = The average of the monthly RPI figures for the financial year $_t$
divided by
the average of the monthly RPI figures for the financial year 2001/2

² All Items (CHAW) index, source: National Statistics.

3 Rolling Forward the UKATS RAB

This section describes how the UKATS RAB will be rolled forward from one year to another. It is divided into two parts:

- the calculation of the UKATS RAB
- the calculation of the capitalised financing costs to be added to the RAB

3.1 Calculation of the UKATS RAB

The opening 2001/2002 RAB was set at £611.0 million (expressed in 1999/2000 prices). This will be increased by 12%. Consequently, the opening 2001/2002 RAB will now equate to £684.320 million in 1999/2000 prices. Thereafter, the opening RAB is to be calculated as follows:

$$\begin{aligned} \text{Opening RAB}_t \quad & \text{(where } t = \text{relevant financial year)} & = & \text{For the financial year 2001/2, this figure has been set according to the following formula:} \\ & & & (\text{£611.0 million} \times (1 + 12.0\%)) \times \text{RPI Growth from 1999/2000}_t \\ & & = & \text{For the remaining financial years, this figure will be set according to the following formula:} \\ & & & \text{Closing RAB}_{t-1} \times \text{Annual RPI Growth}_t \end{aligned}$$

The closing RAB is to be calculated (in financial year-end prices), according to the following formulae:

$$\begin{aligned} \text{Closing RAB}_t & = & \text{Opening RAB}_t & + & (\text{Total net actual Capex}_t \times \text{within-year RPI Growth}_t) \\ & & & + & \text{Capitalised Financing Costs}_t \\ & & & + & \text{Actual Movements in Working Capital}_t \\ & & & - & (\text{ERG's Assumed Ordinary Depreciation}_t \times \text{RPI Growth from 1999/2000}_t) \\ & & & - & (\text{Pricing Profile Adjustment}_t \times \text{RPI Growth from 1999/2000}_t) \end{aligned}$$

Whilst the mechanism for calculating the opening RAB has been addressed above, several other components of this equation are expanded upon below.

$$\begin{aligned} \text{Actual Movements in Working Capital}_t & = & \text{Changes in UKATS working capital in the audited NERL regulatory accounts in the financial year } t. \\ & & & \text{This is the closing UKATS working capital (in outturn prices) from the regulatory accounts minus \{opening UKATS working capital (in outturn prices) multiplied by the Annual RPI growth for that year\}.} \end{aligned}$$

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ERG's Assumed Ordinary UKATS Depreciation t = For each financial year, figures are fixed at the following values (in 1999/2000 prices):

Financial year 2001/2: £ 41.754 million

Financial year 2002/3: £ 57.821 million

Financial year 2003/4: £ 60.657 million

Financial year 2004/5: £ 59.181 million

Financial year 2005/6: £ 65.565 million

Pricing Profile Adjustment t = For each financial year, figures are fixed at the following values (in 1999/2000 prices):

Financial year 2001/2: £ 17.791 million

Financial year 2002/3: £ 17.791 million

Financial year 2003/4: £ 17.791 million

Financial year 2004/5: £ 17.791 million

Financial year 2005/6: £ 17.791 million

3.2 Calculating the capitalised financing costs to be added to the UKATS RAB

This section calculates the amount of capitalised financing costs that need to be added to the RAB. The price control in the first Control Period does not include a return on all the assets included in the RAB. The financing costs of assets that are not remunerated during the first quinquennium are capitalised and added to the RAB, so that they can be recovered in future review periods. The equations below are consistent with the derivation of the allowed revenue during the first quinquennium.

$$\begin{aligned}
 \text{Capitalised Financing Costs } t &= [\{ (\text{Total net actual Capex } t \times \text{Within-year RPI Growth } t) \\
 &\quad - (\text{ERG's Assumed Transfers to Current RAB } t \times \text{RPI Growth from 1999/2000 } t) \} / 2 \\
 &\quad + (\text{Opening Non-Remunerated Assets for the purposes of RAB Calculation } t)] \\
 &\quad \times \text{ the prevailing cost of capital determined by the CAA for UKATS which is currently 7.75\% (pre-tax real)}
 \end{aligned}$$

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Where:

Total net actual Capex_t = Additions to UKATS tangible fixed assets in the financial year t (on an accruals basis) from the audited regulatory accounts,

- the proceeds of disposals of UKATS tangible fixed assets from the audited regulatory accounts
- any grants or contributions to UKATS fixed assets from the audited regulatory accounts.

ERG's Assumed Transfers to Current RAB_t = For each financial year, figures are fixed at the following values (in 1999/2000 prices):

Financial year 2001/2: £ 170.221 million

Financial year 2002/3: £ 75.702 million

Financial year 2003/4: £ 31.537 million

Financial year 2004/5: £ 22.845 million

Financial year 2005/6: £ 73.583 million

Opening Non-Remunerated Assets for the purposes of the RAB Calculation_t = For the financial year 2001/2, this figure will be set according to the following formula:
£135.715 million x RPI Growth from 1999/2000_t

= For the remaining financial years, this figure will be set according to the following formula:
Closing Non-Remunerated Assets for the Purposes of RAB Calculation_{t-1} x Annual RPI Growth_t

Closing Non-Remunerated Assets for the purposes of the RAB Calculation_t = Opening Non-Remunerated Assets for the Purposes of RAB Calculation_t

+ (Total net actual Capex_t x Within Year RPI Growth_t)

- (ERG's Assumed Transfers to Current RAB_t x RPI Growth from 1999/2000_t)

+ Capitalised Financing Costs_t

4 Rolling Forward the Oceanic RAB

This section describes how the Oceanic RAB will be rolled forward from one year to another. It is divided into two parts:

- The calculation of the Oceanic RAB; and
- Calculation of the capitalised financing costs to be added to the Oceanic RAB;

The steps for calculating the Oceanic RAB mirror those of the RAB, except that there is no price profiling adjustment for the Oceanic RAB.

4.1 Calculation of the Oceanic RAB

The opening 2000/01 Oceanic RAB is set to £13.0 million, in 1999/2000 prices. Thereafter, the Oceanic RAB is calculated according to the following formulae:

$$\begin{aligned} \text{Opening Oceanic RAB}_t &= \text{For the financial year 2001/2, this figure will be set} \\ &\quad \text{according to the following formula:} \\ &\quad \text{£13.00 million} \times \text{RPI Growth from 1999/2000}_t \\ &= \text{For the remaining financial years, this figure will be set} \\ &\quad \text{according to the following formula:} \\ &\quad \text{Closing Oceanic RAB}_{t-1} \times \text{Annual RPI Growth}_t \end{aligned}$$

The closing Oceanic RAB will be calculated as follows:

$$\begin{aligned} \text{Closing Oceanic RAB}_t &= \text{Opening Oceanic RAB}_t \\ &+ (\text{Total net actual Oceanic Capex}_t \times \text{Within Year RPI Growth}_t) \\ &+ \text{Oceanic Capitalised Financing Costs}_t \\ &+ \text{Actual Movements in Oceanic Working Capital}_t \\ &- (\text{ERG's Assumed Oceanic Depreciation}_t \times \text{RPI Growth from} \\ &\quad \text{1999/2000}_t) \end{aligned}$$

Whilst the mechanism for calculating the opening RAB has been addressed above. Several other components of this equation are expanded upon below.

$$\begin{aligned} \text{Actual Movements in} \\ \text{Oceanic Working Capital}_t &= \text{Changes in the Oceanic working capital in the NERL} \\ &\quad \text{regulatory accounts in the financial year } t. \\ &\quad \text{This is the closing Oceanic working capital (in outturn prices)} \\ &\quad \text{from the regulatory accounts minus \{opening Oceanic working} \\ &\quad \text{capital (in outturn prices) multiplied by the Annual RPI growth} \\ &\quad \text{for that year\}. \end{aligned}$$

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ERG's Assumed Oceanic Depreciation_t in 1999/2000 prices = For each financial year this figure will be fixed at the following values:

Financial year 2001/2:	£ 0.965 million
Financial year 2002/3:	£ 0.937 million
Financial year 2003/4:	£ 0.879 million
Financial year 2004/5:	£ 1.034 million
Financial year 2005/6:	£ 1.041 million

4.2 Calculating the capitalised financing costs to be added to the Oceanic RAB

Oceanic Capitalised Financing Costs_t = [{ (Total net actual Oceanic Capex_t x within year RPI Growth_t)

- (ERG's Assumed Transfers to Current Oceanic RAB_t x RPI Growth from 1999/2000_t) } /2]

+ Opening Non-Remunerated Assets for the purposes of Oceanic RAB Calculation_t]

x the prevailing cost of capital determined by the CAA for Oceanic which is currently 8.0% (pre-tax real).

Where:

Total net actual Oceanic Capex_t = Additions to Oceanic tangible fixed assets in the financial year t (on an accruals basis) from the audited regulatory accounts,

- the proceeds of disposals of Oceanic tangible fixed assets from the audited regulatory accounts

- any grants or contributions to Oceanic fixed assets from the audited regulatory accounts.

ERG's Assumed Transfers to Current Oceanic RAB_t in 1999/2000 prices = For each financial year this figure will be fixed at the following values:

Financial year 2001/2:	£ 2.052 million
Financial year 2002/3:	£ 1.478 million
Financial year 2003/4:	£ 1.330 million
Financial year 2004/5:	£ 1.970 million
Financial year 2005/6:	£ 1.872 million

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Opening Non-Remunerated Assets for the purposes of Oceanic RAB Calculation t = For the financial year 2001/2, this figure will be set according to the following formula:
 $\pounds 2.443 \text{ million} \times \text{RPI growth from } 1999/2000_t$

= For the remaining financial years, this figure will be set according to the following formula:
 Closing Non-Remunerated Assets for the Purposes of Oceanic RAB Calculation $t-1 \times \text{Annual RPI growth}_t$

Closing Non-Remunerated Assets for the purposes of Oceanic RAB Calculation t = Opening Non-Remunerated Assets for the Purposes of Oceanic RAB Calculation t

- (ERG's Assumed Transfers to Current Oceanic RAB $t \times \text{RPI growth from } 1999/2000_t$)

+ (Total Actual Oceanic Capex $t \times \text{Within Year RPI growth}_t$)

+ Oceanic capitalised financing costs t

5. Operating cost efficiency roll forward

Objective: this mechanism provides an incentive for NATS to lower (and also to not increase) operating costs in each year of Control Period 1 by carrying forward the increases (or decreases) in gains or losses in operating expenditure in the years 2002/3, 2003/4 and 2004/5 into Control Period 2. It is the CAA's intention that this mechanism should operate in a similar manner to that developed by OFWAT in Annex A of MD145³, taking into account differences in the methods of projecting operating costs.

The benchmark for assessing whether there have been gains or losses will be the CAA's projections of regulatory operating expenditure on which its advice to the DETR in 2000 was based.

The roll forward mechanism will identify the present value of operating cost out-performance in Control Period 1 and add this to both the UKATS and Oceanic RAB as appropriate at the beginning of 2006/7 for the purpose of setting the charge control condition in Control Period 2. The calculation will be conducted in 2001/2 prices, with any resulting addition to the RAB then being converted into the relevant price level as set out below. For the avoidance of doubt, the following calculations will apply to both the UKATS and Oceanic RAB's.

Addition to RAB at the start of 2006/7 = Addition to RAB at the start of 2006/7 in 2001/2 prices
 X RPI growth from 2001/2 to financial year 2005/6

Incremental out-performance will be calculated for both UKATS and Oceanic in 2001/2 prices. It will be calculated for financial years 2002/3, 2003/4 and 2004/5 according to the following equation.

³ OFWAT (1999), MD145, Annex A, 8 March

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$$\begin{aligned} \text{Incremental outperformance}_t &= (\text{Opex assumed by CAA}_t \text{ in 2001/2 prices} - (\text{actual regulatory Opex from the regulatory accounts}_t / \text{mid-year deflator to 2001/2 prices}_t)) \\ &- (\text{Opex assumed by CAA}_{t-1} \text{ in 2001/2 prices} - (\text{actual regulatory Opex from the regulatory accounts}_{t-1} / \text{mid-year deflator to 2001/2 prices}_{t-1})) \end{aligned}$$

The operating costs assumed by the CAA for both UKATS and Oceanic are summarised below. These numbers will form the benchmark against which out-performance will be assessed.

Opex assumed by CAA_t (2001/2 prices) = For relevant financial years this figure will be fixed at the following values:

<i>Financial year:</i>	UKATS	OCEANIC
2001/2	£372.651 million	£18.015 million
2002/3	£350.591 million	£18.788 million
2003/4	£355.492 million	£19.412 million
2004/5	£359.774 million	£19.505 million

The incremental out-performance in each of years 2, 3 and 4 of Control Period 1 is calculated as described above. This is then added to the opening RAB for Control Period 2 as follows. In year 1 of Control Period 2, the incremental out-performance of years 2, 3 and 4 of Control Period 1 is summed to arrive at the amount for the year. In year 2 of Control Period 2, the amount is the sum of the incremental out-performance of years 3 and 4 of Control Period 1. In year 3 of Control Period 2, the incremental out-performance of year 4 of Control Period 1 applies.

The amounts to be added to the RAB for years 1, 2 and 3 of Control Period 2 are discounted back to the beginning of Control Period 2 using a mid-year discount factor based on the prevailing regulatory cost of capital (recognising that the regulatory cost of capital as applied to UKATS and Oceanic could differ). The discounted amounts to be added to the RAB are then summed to determine the amount to be added to the RAB at the beginning of Control Period 2.

$$\begin{aligned} \text{Addition to RAB at the start of 2006/7 (in 2001/2 prices)} &= \text{Incremental out-performance (in 2001/2 prices) for financial year 2002/3} \times \\ &\left\{ \frac{1 + (\text{CP2 regulatory cost of capital} \times 0.5)}{1 + \text{CP2 regulatory cost of capital}} \right\} \\ &+ \text{Incremental out-performance in 2001/2 prices for financial year 2003/4} \times \\ &\left\{ \frac{1 + (\text{CP2 regulatory cost of capital} \times 0.5)}{1 + \text{CP2 regulatory cost of capital}} + \right. \\ &\left. \frac{1 + (\text{CP2 regulatory cost of capital} \times 0.5)}{(1 + \text{CP2 regulatory cost of capital})^2} \right\} \end{aligned}$$

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+ Incremental out-performance in 2001/2 prices for financial year 2004/5 x

$$\left\{ \frac{1 + (\text{CP2 regulatory cost of capital} \times 0.5)}{1 + \text{CP2 regulatory cost of capital}} + \right.$$

$$\frac{1 + (\text{CP2 regulatory cost of capital} \times 0.5)}{(1 + \text{CP2 regulatory cost of capital})^2} +$$

$$\left. \frac{1 + (\text{CP2 regulatory cost of capital} \times 0.5)}{(1 + \text{CP2 regulatory cost of capital})^3} \right\}$$

The CAA expects NATS' published annual regulatory accounts to explicitly record both incremental and cumulative out-performance, to aide transparent accounting for the roll-forward mechanism.

6. RAB clawback mechanism

The RAB clawback mechanism facilitates the recovery (or clawback) to users of the revenues gained by NATS as a consequence of the 12% uplift in the 2001/2002 UKATS RAB. The mechanism is calibrated such that, should NATS' performance exceed benchmark expectations in the period to 2010, users will benefit from a clawback of the uplift.

The mechanism operates as follows:

- NERL's net actual operating cash flows between 2003/4 and 2009/10 ((pre-finance and tax expenses), less capital expenditure) are to be compared in net present value terms, against a pre-determined 'benchmark' that has been calibrated by the CAA at a benchmark level of 80% of NERL's forecast cash flows for this period in net present value terms. These forecasts are taken to be those in the 'NATS base case', provided to the CAA in the form of a financial model;⁴
- Should the net present value of NERL's actual cash flows exceed the benchmark threshold over this period, the mechanism reduces the opening 2011/12 UKATS RAB by a clawback rate of 40% of the difference between actual and forecast cash flows;
- The maximum potential amount to be clawed-back would be equivalent to the original RAB uplift in present value terms in 2001/2 prices (£52.8 million). The discount rate for determining the present vale equivalent of the RAB uplift will be the regulatory cost of capital over the relevant period; 7.75% pre-tax real for the current control period and the regulatory cost of capital to be set for the second control period;
- For the purposes of calculating the benchmark cash flow and the actual cash flow compared to it, the starting value of the sum of the UKATS and Oceanic RABs⁵ in 2003/4 will count as

⁴ NATS financial model v06

⁵ The reference to the sum of the UKATS and Oceanic RABs is an agreed correction of a minor error in Annex 4 of the CAA Decision published in March 2003.

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a “negative” cash-flow contribution, and the closing value of the RAB in 2009/10 will count as a “positive” cash-flow contribution.

The UKATS RAB clawback will be calculated in 2011/12 and taken into account in establishing the charge control cap for the third control period. This price adjustment will take the following form:

$$\begin{aligned} \text{UKATS RAB clawback,} &= \text{Appropriate deduction from UKATS RAB at the beginning of} \\ \text{2011/12} & \text{2011/12 in 2001/2 prices} \\ & \times \text{RPI growth from 2001/2 to financial year 2010/11} \end{aligned}$$

The magnitude of the deduction from the UKATS RAB will be determined as follows:

$$\begin{aligned} \text{Appropriate deduction} &= \text{The minimum of:} \\ \text{from UKATS RAB at the} & \text{£52.8 million (the present value in 2001 of the RAB uplift, in} \\ \text{beginning of 2011/12 in} & \text{2001/2 prices); or} \\ \text{2001/2 prices} & \text{(Maximum (total actual NERL cashflow (2003/4 through} \\ & \text{2009/10) – total benchmark cashflow) * 40\% clawback rate), 0)} \\ & \text{Multiplied by:} \\ & \text{(1+7.75\%)^5 x (1 + regulatory cost of capital for CP2)^5)} \end{aligned}$$

For the purposes of the RAB clawback calculation, NERL cashflows are to be calculated as follows:

$$\begin{aligned} \text{NERL cashflows for a relevant} &= \text{(NERL's net cash flow from operating activities in financial} \\ \text{financial year}_t \text{ (in 2001/2 prices)} & \text{year}_t \text{ from the cash flow analysis in NERL's audited} \\ & \text{regulatory accounts} \\ & - \text{NERL's net capital expenditure in financial year}_t \text{ from the} \\ & \text{cashflow analysis in NERL's audited regulatory accounts))} \\ & \text{Divided by mid-year deflator to 2001/2 prices}_t \end{aligned}$$

The benchmark cashflow against which the RAB clawback will be calculated has been pre-determined by the CAA. The basis for this predetermination was as follows:

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$$\begin{aligned} \text{Total benchmark forecast NERL cashflow} &= \left[80\% \times \sum_{t=2003/4}^{2009/10} \left\{ \frac{\text{Benchmark NERL cashflows}_t}{\text{Mid year discount factor}_t} \right\} \right] \\ &- \text{Forecast closing 2002/3 RAB of } \pounds 618.2 \text{ million}^6 \\ &+ \text{Forecast closing 2009/10 RAB of } \pounds 884.1 \text{ million divided by } ((1 + 7.75\%)^5 \times (1 + \text{regulatory cost of capital for CP2})^4) \end{aligned}$$

The benchmark cashflow against which the RAB clawback will be calculated has been pre-determined by the CAA as follows:

Benchmark NERL cashflows _t	=	Benchmark cashflows are:
		Financial year 2003/4: \pounds 91.6 million
		Financial year 2004/5: \pounds 34.8 million
		Financial year 2005/6: \pounds 93.7 million
		Financial year 2006/7: \pounds 59.7 million
		Financial year 2007/8: \pounds 70.8 million
		Financial year 2008/9: \pounds 58.5 million
		Financial year 2009/10: \pounds 70.0 million

Actual NERL cashflows between financial years 2003/4 and 2009/10 inclusive will be calculated as follows:

$$\begin{aligned} \text{Total actual NERL cashflow} &= \sum_{t=2003/4}^{2009/10} \left\{ \frac{\text{NERL cashflows in 2001/2 prices}_t}{\text{Mid year discount factor}_t} \right\} \\ &- (\text{Closing 2002/3 UKATS plus Oceanic RABs divided by RPI growth from 2001/2 to 2002/3}) \text{ divided by } (1+7.75\%)^2 \\ &+ (\text{Closing 2009/10 UKATS plus Oceanic RABs divided by RPI Growth from 2001/2 to 2009/10} \times (1+7.75\%)^5 \times (1 + \text{CP2 regulatory cost of capital})^4) \end{aligned}$$

Mid year discount factor _t	=	For each financial year this figure will be fixed at follows:
		Financial year 2001/2: $(1+7.75\%) / (1+(7.75\%*0.5))$
		Financial year 2002/3: $(1+7.75\%)^2 / (1+(7.75\%*0.5))$
		Financial year 2003/4: $(1+7.75\%)^3 / (1+(7.75\%*0.5))$

⁶ Discounted at 7.75%²

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16 March 2005

Financial year 2004/5:	$(1+7.75\%)^4 / (1+(7.75\%*0.5))$
Financial year 2005/6:	$(1+7.75\%)^5 / (1+(7.75\%*0.5))$
Financial year 2006/7:	$((1+7.75\%)^5*(1+ \text{CP2 regulatory cost of capital}))$ $/(1+ (\text{CP2 regulatory cost of capital } *0.5))$
Financial year 2007/8:	$((1+7.75\%)^5*(1+ \text{CP2 regulatory cost of capital})^2)$ $/(1+ (\text{CP2 regulatory cost of capital } *0.5))$
Financial year 2008/9:	$((1+7.75\%)^5*(1+ \text{CP2 regulatory cost of capital})^3)$ $/(1+ (\text{CP2 regulatory cost of capital } *0.5))$
Financial year 2009/10:	$((1+7.75\%)^5*(1+ \text{CP2 regulatory cost of capital})^4)$ $/(1+ (\text{CP2 regulatory cost of capital } *0.5))$

The CAA expects NATS' published regulatory accounts to explicitly record the progress of this on a year-by-year basis.

ANNEX 5 PRINCIPLES OF COST ALLOCATION

1. GENERAL COST ALLOCATION PRINCIPLES

- 1.1 The following key principles underlie the approach the NATS Group is taking in order to meet the business and regulatory requirements. The principles will be developed over time as these requirements develop. References to allocation include, where appropriate, attribution or apportionment.
- 1.2 NATS' costing approach is based on activity based costing principles. These will be applied as follows:
- (a) Where costs relate wholly to one Service Line or Condition 9 Business Sector⁷, they will be driven direct to that Service Line/ Sector.
 - (b) For costs which do not relate wholly to one Service Line or Condition 9 Business Sector, where appropriate, a market test approach will be adopted. However, it is recognised that market based charging will not be possible for most NATS internal transactions for some time and therefore the following principles will be used:
 - (i) Cost allocations will as far as possible be based on drivers which are appropriate and quantifiable drivers of the cost
 - (ii) Where possible, costs related to associated activities or assets will be grouped together and allocated on a common basis
 - (iii) Where appropriate, Holding company costs are charged or allocated to activities in the two subsidiaries, for recovery of the costs from external customers
 - (iv) Overhead costs should where possible be allocated to an activity that can subsequently be driven to a service line
 - (v) Where a secondary user has the benefits of a facility or activity, costs will be allocated using the most appropriate basis, recognising that:
 - (1) Where the secondary user does not use the full functionality of the facility, the secondary user should only bear a charge appropriate to the service used.
 - (2) Secondary users should not suffer unnecessarily from the decisions of the primary user (for example, to move to a new or more sophisticated facility), but should pay appropriately for the services they get and use.

⁷ The term "Condition 9 Business Sector" refers to Condition 9 of the Licence which prohibits cross subsidy between the Separate Businesses or parts of a Separate Business where that cross subsidy has or is intended to have or is likely to have the effect of preventing, restricting or distorting competition in any market for the provision of air traffic services. Separate Business is defined in Annex 1.

- (3) The cost to the secondary user should not exceed the standalone cost.

2. **PROCESS**

- 2.1 Charges and cost allocations will be used both within companies and between companies, reflecting internal customer/supplier relationships and the ultimate need to drive costs through to Service Lines and Condition 9 Business Sectors. The process is implemented in two stages:
- (a) Charging between divisions, which will include inter-company charging, in order to provide divisional cost bases that are aligned with the Service Lines for which the divisions are responsible.
 - (b) Allocations of the resulting costs between Service Lines.
- 2.2 Cost allocations are carried out using activity based costing principles which are applied in a two stage process:
- (a) allocate costs to the activities or tasks they perform;
 - (b) allocate the costs of activities to the products or services they provide to customers.
- 2.3 It is proposed that costs initially be allocated on the basis of the plan figures, followed by an appropriate allocation of the variance reflecting the reasons for it. This area is complex and will be subject to ongoing review.
- 2.4 For balance sheet and depreciation charge purposes, fixed assets are attributed to or allocated between service lines by individual asset, following the same general principles of usage that are applied to operating costs.