

NATS (EN ROUTE) PLC REGULATORY ACCOUNTING GUIDELINES

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Note

The present issue, Issue 5, of the Regulatory Accounting Guidelines reflects the CAA's Decision on the NERL 2006-2010 price control review and NERL's adoption of International Financial Reporting Standards (IFRS) for statutory reporting purposes.

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.

Annex 1 summarises the key definitions from the Licence.

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 The regulatory accounts will include a profit and loss account to the level of profit before interest and tax (PBIT) for NERL and for each of the three segments defined below:

- the En route (UK) Business;
- the En route (Oceanic) Business ("Oceanic"); and
- Other permitted business.

- 4.2 The regulatory accounts will include a statement of capital employed, excluding funding and tax balances, and an operating cash flow analysis, for:

- UK Air Traffic Services (UKATS) which comprises the En route (UK) Business and the other permitted business as set out in paragraph 4.1 above;
- Oceanic; and
- NERL.

This structure is illustrated in Annex 2.

- 4.3 A reconciliation between the regulatory accounts and the statutory accounts for NERL will be included for each of profit and loss account, capital employed and cash flow analysis.
- 4.4 The regulatory accounts will include the following statements which track NERL's

performance against the CAA's regulatory determination:

- 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), except that, for 2005/06, it is agreed that this statement does not need to be produced; and
- a record of the actual and benchmark cash flows for the purpose of the RAB clawback (section 7 of Annex 4 of the CAA Decision).

These regulatory tracking statements will be prepared for UK Air Traffic Services and Oceanic, which are the basis of the price control for Control Period 2 (CP2).

A record of the RPI indices used to convert between price bases in these statements will be maintained.

- 4.5 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.
- 4.6 The regulatory accounts will include a financial commentary. This will supplement the operating and financial reviews in the NATS group and NERL accounts. The analysis will comment on the segmental results and on actual performance compared with the regulatory determination.
- 4.7 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 Appendix 3 of the CAA Decision (December 2005) requires that the regulatory accounts should be prepared according to accounting policies that are consistent with the basis used in the CP2 price control determination, which was UK Generally Accepted Accounting Principles (UK GAAP), and that any change in the company's accounting policies for statutory accounts, whether required by new accounting standards or otherwise, that would have a material effect on the amounts used in formulae defined in Appendix 3 should thus be disregarded in the regulatory accounts unless the CAA consents to such a change.
- 5.2 From 2005/06 onwards, the NERL statutory accounts are being produced on the basis of International Financial Reporting Standards (IFRS). In conjunction with NATS, the CAA has reviewed the impact of the adoption of IFRS on the regulatory statements. Fixed assets reclassified under IFRS from tangible to intangible (principally software) will continue to be included in fixed assets for the purposes of the regulatory statements. The quantitative impacts of the other changes resulting from the implementation of IFRS are not material and accordingly the CAA confirms that the regulatory statements should be prepared using accounting amounts derived on an IFRS basis.
- 5.3 The intangible asset, and any associated amortisation or impairment, that appear in the statutory accounts of NERL as a result of the PPP transaction are not included in the regulatory accounts because they are not recognised for the purposes of economic regulation.
- 5.4 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.

5.5 The segmental accounting results are presented on a historical cost basis.

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.

London 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.

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.

ANNEX 2 NERL SEGMENTS FOR THE PURPOSES OF THE REGULATORY ACCOUNTS

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

NERL				
UK Air Traffic Services				Oceanic
En route (UK) Business			Other permitted business	
Eurocontrol	North Sea Helicopters	London Approach		

Notes

1. UK Air Traffic Services (UKATS) and Oceanic provided the basis for the price control for Control Period (CP) 2.
2. Three elements of UKATS - Eurocontrol, London 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.
3. Other Permitted Business comprises turnover from other classes of business explicitly permitted under Condition 5, paragraph 12 of the Licence including transactions with the crown. This comprises
 - (a) NERL's contract with the Ministry of Defence. .
 - (b) Cross Charges to NATS (Services) Ltd., which represent the trading from NERL to NATS (Services) Ltd..
 - (c) 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)).

ANNEX 3: PROFORMA NERL REGULATORY ACCOUNTS**Contents**

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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 5-7);
- the tracking of the regulatory asset base, including an explanation of the differences between the regulator's assumptions and the outturn (section 8);
- performance (revenues, costs and the return) compared with the regulatory determination (section 9);
- performance under the rolling incentive mechanism (section 10); and
- the RAB clawback (section 11).

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	Current year				Prior year			
	En route (UK) Business	Oceanic	Other permitted business	NERL	En route (UK) Business	Oceanic	Other permitted business	NERL
<u>Turnover</u>								
External								
Intra group								
Total								
<u>Operating Costs</u>								
People costs								
Services and materials								
Repairs and maintenance								
External research and								
Other operating charges								
Depreciation								
Capitalisation of internal costs								
Intra group allocated charges								
Total net operating costs								
Profit before interest and tax								

For 2005/06 only, the comparatives will be stated using the UKATS/Oceanic structure which was used for reporting in 2004/05.

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>			
	En route (UK) Business	Oceanic	Other permitted business	NERL
<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	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	UKATS		Oceanic		NERL.	
	Year	Prior year	Year	Prior year	Year	Prior year
Year ended 31 March						
Fixed assets (Note 1)						
Current assets						
less: Current liabilities						
Capital employed						

£m	Year	Prior year
Total NERL capital employed as above		
Intangible asset arising from PPP transaction		
Provisions for liabilities and charges		
Pension balances		
Other inter-company debtor/creditor		
Cash		
Tax items:		
Corporation tax		
Deferred tax		
Loans		
Facility fees		
Any other reconciling items		
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

- Fixed assets comprise tangible and intangible assets (except the intangible asset arising as a result of the PPP transaction, which is excluded) as defined for statutory accounts purposes. Amounts are shown net of grants and other contributions. Movements in fixed assets are set out in the note below.
- Working capital excludes cash, funding and tax balances.

Movements in 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		
Fixed assets per the regulatory accounts		
add: grants and other contributions towards fixed assets		
Property, plant and equipment and intangible fixed asset per the statutory accounts (excluding the intangible asset arising from the PPP transaction)		

7. CASH FLOW ANALYSIS BY SEGMENT

£m Year ended 31 March	Current year			Prior year		
	UKATS	Oceanic	NERL	UKATS	Oceanic	NERL
Profit/(loss) before interest and tax						
Depreciation						
Loss/(profit) on sale of tangible fixed assets						
(Increase)/decrease in debtors						
Increase/(decrease) in creditors						
Net cash inflow from operating activities						
Capital expenditure (Note (a))						
Net cash flow						

	Current year	Prior year
NERL cash flow (as above)		
(Increase)/decrease in provisions		
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 analyses for these two segments are prepared from the accounting records of the company and include apportionments.

a) Capital expenditure

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

The definitions and formulae for the rolling forward of the UKATS and Oceanic Regulatory Asset Bases (RABs) during 2005/06 and CP2 are set out in Annex 4, sections 3 and 4.

The regulatory accounts will include the following statements for each of UKATS and Oceanic, with all amounts stated at year-end price levels :

	Current Year			Prior Year		
	Actual	CAA's projection	Variance	Actual	CAA's projection	Variance
Closing RAB for previous year						
+ CP1 capitalised financing costs						
+ total actual net capital expenditure for the year						
+ pension contribution variance for the year						
+ capitalised financing costs for the year						
+ real movements in working capital for the year						
- allowed underlying depreciation for the year						
+ backlog adjustments to allowed depreciation for the year (UKATS only)						
Closing RAB						

The CAA projections are shown below; further detail is provided in Annex 4.

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	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
£'000 in 2003/4 prices (CHAW=182.5)						
UKATS RAB						
Opening RAB	744,274	809,115	922,906	981,380	971,378	941,901
Net capex	143,619	186,657	126,806	74,736	70,030	82,942
Pension contribution variance	0	0	0	0	0	0
Capitalised financing costs	11,369	0	0	0	0	0
Real movements in working capital	1,273	-776	14,324	4,147	-4,785	-5,133
Underlying depreciation	-91,421	-90,643	-101,210	-107,438	-113,274	-120,185
Backlog adjustment to depreciation	0	18,553	18,553	18,553	18,553	18,553
Closing RAB	<u>809,115</u>	<u>922,906</u>	<u>981,380</u>	<u>971,378</u>	<u>941,901</u>	<u>918,078</u>
Oceanic RAB						
Opening RAB	19,352	23,734	23,759	21,965	20,505	18,514
Net capex	4,692	418	656	1,105	500	405
Pension contribution variance	0	0	0	0	0	0
Capitalised financing costs	474	0	0	0	0	0
Rolling incentive mechanism adjustment	0	1,352	0	0	0	0
Real movements in working capital	359	618	-31	-55	62	-0
Depreciation	-1,142	-2,364	-2,418	-2,510	-2,552	-2,586
Closing RAB	<u>23,734</u>	<u>23,759</u>	<u>21,965</u>	<u>20,505</u>	<u>18,514</u>	<u>16,333</u>

As stated in Annex 4, the opening UKATS and Oceanic RABs, at 31 March 2005, are £776.9m and £20.2m at outturn prices.

A history of each the closing RABs (UKATS and Oceanic) year by year will be included, recording the total RAB as projected by the CAA and the outturn figures:-

Closing RAB

At 31 March, £ million at outturn prices	2005	2006	2007	etc.
Actual				
CAA projection				

9. COMPARISON OF PERFORMANCE WITH THE REGULATORY ASSUMPTIONS

This statement presents the performance of the regulated businesses, measured on the basis used by the CAA in its price determination. It shows the actual performance, the projections assumed by the CAA in its charge control and the variance between them. Performance is analysed separately for UKATS and Oceanic.

For 2005/06, this statement is shown on two bases:

- Comparison of actuals with the projections assumed by the CAA for the CP1 charge control, and
- Comparison of actuals with the projections assumed by the CAA for the CP2 charge control.

9.1 Performance compared with the CAA's projections for CP1

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

(Year ended 31 March - £ million)	Actual	CAA's Projection	Variance
Revenue (Note 2)			
Costs:			
- Operating costs (Note 3)			
- Depreciation assumed in price control (Note 4)			
- Price profiling adjustment (UKATS only; 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

1. 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, capitalised financing costs 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 from the segmental profit and loss account (section 5), including inter company revenue.
3. Operating costs are operating costs from the segmental profit and loss account (at section 5), less depreciation, amortisation and impairment charges and after eliminating the profit or loss on asset disposals. Costs are gross of the cost of sales to other group companies.
4. The calculation uses the forecast of depreciation that was assumed in the price control, rather than the depreciation used in the segmental 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 CP1 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. 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. 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.
8. The rate of return in the CAA's projection column is the allowed cost of capital.

The CAA's projections for CP1 are as shown below:

<u>CAA's CP1 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

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

<u>CAA's CP1 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

A commentary on the variances will be included.

9.2 Performance compared with the CAA's projections for CP2

This statement follows the methodology adopted by the CAA for the CP2 review.

UKATS	Actual	CAA's Projection	Variance
(Year ended 31 March - £ million)			
- Eurocontrol and London Approach Revenue			
- Other income			
- Inter-company income			
UKATS Revenue			
Costs:			
- Operating costs excluding pensions			
- Pension cash cost			
- Underlying Depreciation			
- Backlog adjustment to depreciation (zero in 2005/06)			
Total costs			
Regulatory profit			
Capitalised financing costs			
Regulatory return			
Average RAB			
Regulated rate of return			

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Oceanic	Actual	CAA's Projection	Variance
(Year ended 31 March - £ million)			
Oceanic Revenue			
Costs:			
- Operating costs excluding pensions			
- Pension cash cost			
- Depreciation			
Total costs			
Regulatory profit			
Capitalised financing costs			
Regulatory return			
Average RAB			
Regulated rate of return			

The CAA's CP2 projections are set out below.

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	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
£'000 in 2003/4 prices (CHAW=182.5)						
UKATS Regulatory Performance Statement						
Price control	453,394	448,060	444,278	441,008	440,305	444,318
Other income	51,556	46,807	46,289	46,022	46,246	46,164
Intercompany income	10,614	11,997	10,916	10,001	8,980	8,878
UKATS Revenue	<u>515,563</u>	<u>506,865</u>	<u>501,482</u>	<u>497,031</u>	<u>495,530</u>	<u>499,360</u>
Operating costs excluding pensions	-318,962	-324,670	-330,693	-324,655	-328,742	-304,479
Pension cash cost	-20,755	-23,284	-26,571	-34,652	-34,790	-35,328
Underlying depreciation	-91,421	-90,643	-101,210	-107,438	-113,274	-120,185
Backlog adjustment to depreciation	<u>0</u>	<u>18,553</u>	<u>18,553</u>	<u>18,553</u>	<u>18,553</u>	<u>18,553</u>
Regulatory profit	84,426	86,821	61,561	48,839	37,278	57,920
Capitalised Financing Costs	<u>11,369</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Regulatory return	95,794	86,821	61,561	48,839	37,278	57,920
Average RAB	<u>776,694</u>	<u>866,011</u>	<u>952,143</u>	<u>976,379</u>	<u>956,640</u>	<u>929,990</u>
Regulated rate of return	<u>12.33%</u>	<u>10.03%</u>	<u>6.47%</u>	<u>5.00%</u>	<u>3.90%</u>	<u>6.23%</u>
Oceanic Regulatory Performance Statement						
Oceanic Revenue	20,173	20,135	20,076	20,024	19,951	19,917
Operating costs excluding pensions	-14,796	-14,802	-14,685	-14,998	-14,365	-14,300
Pension cash cost	-1,081	-1,185	-1,304	-1,761	-1,708	-1,691
Depreciation	<u>-1,142</u>	<u>-2,364</u>	<u>-2,418</u>	<u>-2,510</u>	<u>-2,552</u>	<u>-2,586</u>
Regulatory profit	3,154	1,785	1,669	755	1,326	1,340
Capitalised Financing Costs	<u>474</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Regulatory return	3,627	1,785	1,669	755	1,326	1,340
Average RAB	<u>21,543</u>	<u>23,746</u>	<u>22,862</u>	<u>21,235</u>	<u>19,510</u>	<u>17,424</u>
Regulated rate of return	<u>16.84%</u>	<u>7.52%</u>	<u>7.30%</u>	<u>3.56%</u>	<u>6.80%</u>	<u>7.69%</u>

Note: Operating costs include inter-company costs.

A commentary on the variances will be included.

10 OPERATING COST EFFICIENCY ROLLING INCENTIVE MECHANISM

The basis of the operating cost efficiency rolling incentive mechanism in CP2 is set out in Annex 4, section 5.

The operating cost efficiency performance in CP1 has been taken into account in the CAA's Decision and accordingly no rolling incentive mechanism statement will be produced for 2005/06.

11 RECORD OF CASH FLOWS FOR THE PURPOSE OF THE CLAWBACK OF THE UKATS RAB UPLIFT

As explained in section 7 of Annex 4, 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 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 6.75% for the years 2006/7 to 2009/10).

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.

The structure of the statement for 2005/06 is shown below.

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(£ million)	31 March 2003	2003/04	2004/05	2005/06
<u>ACTUAL DATA</u>				
Actual figures from the regulatory accounts				
UK Air Traffic Services RAB at 31 March 2003	725.527			
Oceanic RAB at 31 March 2003	13.597			
Total RAB at 31 March 2003	<u>739.124</u>			
NERL operating cash flow from cash flow statement		194.8	246.1	
less: NERL capital expenditure cash flow from cash flow statement		-80.7	-108.2	
Total NERL actual cash flow		<u>114.1</u>	<u>137.9</u>	
Actual figures at 2001/2 prices				
RAB at 31 March 2003	714.473			
Annual cash flow		108.723	127.422	
Present values (discounted using regulatory cost of capital to 1 April 2001 values)				
RAB at 31 March 2003	615.391			
Annual cash flow		90.278	98.194	
<u>BENCHMARK DATA</u>				
RAB at 31 March 2003 (as stated in CAA Decision, discounted to 1 April 2001)	618.200			
NERL's forecast base case cash flows in 2001/2 prices		91.600	34.8	93.7
Present value of NERL's forecast base case cash flows (2001/2 prices)		76.060	26.818	67.0
<u>Benchmark</u> : 80% of NERL's forecast base case cash flows in present value terms (2001/2 prices)		60.848	21.454	53.6
<i>Note: discount factor back to 1 April 2001 present value</i>	1.161	1.204	1.298	1.398

12. 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 Appendix 3 from "NATS Price Control Review 2006-2010, CAA Decision" (December 2005). As explained in annex 3 above, some parts of this annex do not apply to the regulatory accounts for 2005/06.

1. Introduction

This Appendix summarises the detail of the formulae which will govern the tracking of the Regulatory Asset Base (RAB) for:

- UKATS; and
- Oceanic.

The Appendix 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 for 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;
- *Section 6*: summarises the approach to be taken with respect to pension contributions for the existing benefits to existing staff; and
- *Section 7*: summarises the approach to be employed in 'clawing back' the UKATS RAB uplift, if NERL's performance exceeds a specified level.

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.

Regulatory accounts should be prepared according to accounting policies that are consistent with the basis of the determination values used in this appendix. Any change in the company's accounting policies for statutory accounts, whether required by new accounting standards or otherwise, that would have a material effect on the amounts used in formulae defined in this appendix should thus be disregarded in the regulatory accounts unless the CAA consents to such a change.

2. Inflation indices

Each year, the RAB is expressed in actual end year price levels. The CAA price control calculations were expressed in fixed 2003/04 price levels and these figures must be uplifted, or indexed, to out-turn price terms each year. The formulae in later sections include the necessary indexation calculations with reference to the following definitions for each relevant financial year (designated as year t):

RPI Growth from 2003/04 for year t	= The Retail Prices Index (RPI, as defined in the Licence) for the last month of year t, divided by the average of the monthly RPI figures for the financial year 2003/04 which, based on the All Items index starting at 100 in January 1987 ² , equals 182.5.
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² All Items (CHAW) index, source: National Statistics.

Annual RPI Growth for year t	= The RPI for the last month of year t, divided by the RPI for the last month of the previous financial year (year t-1)
Within-year RPI Growth for year t	= The RPI for the last month of year t, divided by the average of the monthly RPI figures for year t (i.e. April RPI + May RPI + . . . + following March RPI, divided by 12)
RPI Growth from 2001/02 for year t	= The RPI for the last month of year t, divided by the average of the monthly RPI figures for the financial year 2001/02 which, based on the All Items index starting at 100 in January 1987, equals 173.9
Mid-year Deflator to 2001/02 Prices for year t	= The average of the monthly RPI figures for year t, divided by the average of the monthly RPI figures for the financial year 2001/02 (i.e. 173.9)

3. Rolling Forward the UKATS RAB

This section describes how the UKATS RAB will be rolled forward from one year to another. It establishes the starting point for these calculations: the RAB at the end of the last full financial year available to CAA at the time of its price control calculations. It takes into consideration the net capital expenditure made by UKATS, the movements in working capital (e.g. debtors and creditors) and the allowances for depreciation incorporated in the price control calculations. In this way, the RAB is expected to reflect the cash-flow investment made in the assets of the company, net of amounts contributed by customers by way of depreciation allowances.

The price control provides for a return on the RAB, based on assumptions for levels of net capital expenditure, and also provided for an allowance for pensions costs based on assumptions for levels of pension contributions. ERG intends that variances against these assumptions, and their financing cost implications (consistent with the equivalent formulae existing before this modification), are taken into account by making suitable additions or deductions in the RAB calculations.

The following formulae specify how the UKATS RAB will be rolled forward.

The RAB at the end of the last full financial year before CAA's price control calculations, at 31 March 2005 (expressed as £744,500,000 in 2003/04 price terms, in the firm proposals but subsequently subject to a small amendment to reflect the audited position), forms the starting point (after conversion with respect to RPI for March 2005 = 190.5) for subsequent RAB calculations. These calculations are as follows:

$$\begin{array}{l} \text{Closing RAB for financial year 2004/05} \\ \text{(i.e. at 31 March 2005)} \end{array} = \quad \text{£776,900,000}$$

Thereafter, the closing RAB is to be calculated (in outturn financial year-end prices), according to the following formulae (where t is the relevant financial year):

$$\begin{array}{l} \text{Closing RAB for year t} \end{array} = \quad \begin{array}{l} \text{Closing RAB for the previous year} \\ \text{(year t-1)} \times \text{Annual RPI Growth for} \\ \text{year t} \end{array}$$

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- + CP1 Capitalised Financing Costs x RPI Growth from 2003/04 for year t
- + Total Actual Net Capex for year t x Within-year RPI Growth for year t
- + Pension Contribution Variance for year t
- + Capitalised Financing Costs for year t
- + Real Movements in Working Capital for year t
- Allowed Underlying Depreciation for year t x RPI Growth from 2003/04 for year t
- + Backlog Adjustments to Allowed Depreciation for year t x RPI Growth from 2003/04 for year t

Where:

CP1 Capitalised Financing Costs = The amount of capitalised financing costs calculated by ERG in respect of the first control period based on capital expenditure assumptions; figures are fixed at the following values (in 2003/04 prices):

Financial year 2005/06: £11,368,543

Financial year 2006/07: £0

Financial year 2007/08: £0

Financial year 2008/09: £0

Financial year 2009/10: £0

Financial year 2010/11: £0

Total Actual Net Capex for year t = Additions to UKATS tangible fixed assets in year t (on an accruals basis) from the audited regulatory accounts,

- the proceeds of disposals of UKATS tangible fixed assets in year t from the audited regulatory accounts,
- any grants or other contributions (e.g. customer contributions) to UKATS fixed assets for year t from the audited regulatory accounts.

Real Movements in Working Capital for year t = Closing Working Capital for year t

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- Closing Working Capital for year t-1 x Annual RPI Growth for year t

Closing Working Capital for year t = Net UKATS working capital (in outturn prices) at the end of year t derived from the regulatory accounts excluding any debtor, creditor, accrual, prepayment or other provision in respect of financing (e.g. bank accounts, loans, accrued interest and cash), corporation and deferred tax, distributions and, for year 2004/05 and subsequent years, in respect of pension contributions.

For the purpose of this calculation, working capital is defined as debtors and creditors, accruals and prepayments arising from UKATS trading (including transactions in respect of attributable fixed assets)

Allowed Underlying Depreciation for year t = The amount in respect of underlying depreciation allowed for in ERG's price control calculations in the relevant financial year; figures are fixed at the following values (in 2003/04 prices):

Financial year 2005/06: £91,420,516

Financial year 2006/07: £90,642,555

Financial year 2007/08: £101,209,751

Financial year 2008/09: £107,437,792

Financial year 2009/10: £113,273,597

Financial year 2010/11: £120,185,431

Backlog Adjustments to Depreciation for year t = The amount in respect of adjustments to depreciation allowed for in ERG's price control calculations in the relevant financial year; figures are fixed at the following values (in 2003/04 prices, amounts represent a reduction to aggregate allowed depreciation):

Financial year 2005/06: £0

Financial year 2006/07: £18,552,926

Financial year 2007/08: £18,552,926

Financial year 2008/09: £18,552,926

Financial year 2009/10: £18,552,926

Financial year 2010/11: £18,552,926

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CAA anticipates that the backlog adjustments will continue for a further two years in the third control period at the level of £18,552,926 in 2003/04 prices in order to complete the correction of price profiling adjustments and outturn variances in the first control period.

Pension Contribution Variance for year 5 (financial year 2005/06)	=	£0 (zero)
Thereafter, Pension Contribution Variance for year t	=	Total actual pension contributions made (in cash terms) in respect of employees and terms existing at 1 January 2006 for year t x Within-year RPI Growth for year t
	-	ERG's Assumed Pension Contributions for year t x RPI Growth from 2003/04 for year t
ERG's Assumed Pension Contributions	=	For each financial year, figures are fixed at the following values in 2003/04 prices: Financial year 2006/07: £19,893,954 Financial year 2007/08: £21,622,599 Financial year 2008/09: £26,831,387 Financial year 2009/10: £24,852,990 Financial year 2010/11: £24,071,716
Capitalised Financing Costs for year t	=	[{ (Net Capex Variance for year t) + (Pension Contribution Variance for year t) } , Divided by 2 (two) + (Closing Cumulative Capitalised Variances for year t-1 x Annual RPI Growth for year t)] X the cost of capital determined by the CAA for UKATS for year t
Net Capex Variance for year t	=	Total Actual Net Capex for year t x Within-year RPI Growth for year t - ERG's Assumed Net Capex for year t x RPI Growth from 2003/04 for year t
ERG's Assumed Net Capex	=	For each financial year, figures are fixed at the following values in 2003/04 prices:

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Financial year 2005/06: £143,619,272

Financial year 2006/07: £186,656,733

Financial year 2007/08: £126,806,353

Financial year 2008/09: £74,736,495

Financial year 2009/10: £70,029,657

Financial year 2010/11: £82,942,008

Closing Cumulative Capitalised Variances for year 2004/05 (i.e. year t-1 for the financial year 2005/06) = £0 (zero)

Thereafter:

Closing Cumulative Capitalised Variances for year t = Closing Cumulative Capitalised Variances for year t-1 x Annual RPI Growth for year t

+ Net Capex Variance for year t

+ Pension Contribution Variance for year t

+ Capitalised Financing Costs for year t

The cost of capital determined by the CAA for UKATS for year t = For each financial year, figures are fixed at the following values:

Financial year 2005/06: 7.75%

Financial year 2006/07: 6.75%

Financial year 2007/08: 6.75%

Financial year 2008/09: 6.75%

Financial year 2009/10: 6.75%

Financial year 2010/11: 6.75%

The amount of the RAB represented by Closing Cumulative Pension Contribution Variances for year t shall be identified in each year's regulatory accounts. The Closing Cumulative Pension Contribution Variances for year t shall be calculated in the same way as the Closing Cumulative Capitalised Variances for year t except disregarding the Net Capex Variance for year t.

4. Rolling Forward the Oceanic RAB

This section describes how the Oceanic RAB will be rolled forward from one year to another. The steps for calculating the Oceanic RAB mirror those of the UKATS RAB.

The RAB at the end of the last full financial year before ERG's price control calculations, at 31 March 2005 (expressed as £20,100,000 in 2003/04 price terms in the firm proposals but subsequently subject to a small amendment to reflect the audited position), forms the starting point (after conversion with respect to RPI for March 2005 = 190.5) for subsequent RAB calculations. These calculations are as follows:

Closing RAB for financial year
2004/05 (i.e. at 31 March 2005) = £20,200,000

Thereafter, the closing RAB is to be calculated (in outturn financial year-end prices), according to the following formulae (where t=relevant financial year):

Closing RAB for year t	=	Closing RAB for the previous year (year t-1) x Annual RPI Growth for year t
	+	CP1 Capitalised Financing Costs x RPI Growth from 2003/04 for year t
	+	CP1 Rolling Incentive Adjustment for year t x RPI Growth from 2003/04 for year t
	+	Total Actual Net Capex for year t x Within-year RPI Growth for year t
	+	Pension Contribution Variance for year t
	+	Capitalised Financing Costs for year t
	+	Real Movements in Working Capital for year t
	-	Allowed Depreciation for year t x RPI Growth from 2003/04 for year t

Where:

CP1 Capitalised Financing Costs	=	The amount of capitalised financing costs calculated by ERG in respect of the first control period based on capital expenditure assumptions; figures are fixed at the following values (in 2003/04 prices):
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Financial year 2005/06: £473,844

Financial year 2006/07: £0

Financial year 2007/08: £0

Financial year 2008/09: £0

Financial year 2009/10: £0

Financial year 2010/11: £0

CP1 Rolling Incentive Adjustment for year t = The amount in respect of the Rolling Incentive Mechanism calculated by ERG in respect of the first control period; figures are fixed at the following values (in 2003/04 prices):

Financial year 2005/06: £0

Financial year 2006/07: £1,352,365

Financial year 2007/08: £0

Financial year 2008/09: £0

Financial year 2009/10: £0

Financial year 2010/11: £0

Total Actual Net Capex for year t = Additions to Oceanic tangible fixed assets in year t (on an accruals basis) from the audited regulatory accounts,
– the proceeds of disposals of Oceanic tangible fixed assets in year t from the audited regulatory accounts,
– any grants or other contributions (e.g. customer contributions) to Oceanic fixed assets for year t from the audited regulatory accounts.

Real Movements in Working Capital for year t = Closing Working Capital for year t

– Closing Working Capital for year t-1 x Annual RPI Growth for year t

Closing Working Capital for year t = Net Oceanic working capital (in outturn prices) at the end of year t derived from the regulatory accounts excluding any debtor, creditor, accrual, prepayment or other provision in respect of financing (e.g. bank accounts, loans, accrued interest and cash), corporation and deferred tax, distributions

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and, for year 2004/05 and subsequent years, in respect of pension contributions.

For the purpose of this calculation, working capital is defined as debtors and creditors, accruals and prepayments arising from Oceanic trading (including transactions in respect of attributable fixed assets).

Allowed Depreciation for year t	=	The amount in respect of depreciation allowed for in ERG's price control calculations in the relevant financial year; figures are fixed at the following values (in 2003/04 prices):
		Financial year 2005/06: £1,141,722
		Financial year 2006/07: £2,363,568
		Financial year 2007/08: £2,418,203
		Financial year 2008/09: £2,510,263
		Financial year 2009/10: £2,551,908
		Financial year 2010/11: £2,585,656
Pension Contribution Variance for year 5 (financial year 2005/06)	=	£0 (zero)
Thereafter, Pension Contribution Variance for year t	=	Total actual pension contributions made (in cash terms) in respect of employees and terms existing at 1 January 2006 for year t x Within-year RPI Growth for year t
	-	ERG's Assumed Pension Contributions for year t x RPI Growth from 2003/04 for year t
ERG's Assumed Pension Contributions	=	For each financial year, figures are fixed at the following values in 2003/04 prices:
		Financial year 2006/07: £1,012,411
		Financial year 2007/08: £1,061,320
		Financial year 2008/09: £1,363,298
		Financial year 2009/10: £1,220,212
		Financial year 2010/11: £1,152,229

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$$\begin{aligned} \text{Capitalised Financing Costs for year t} &= [\{ (\text{Net Capex Variance for year t}) \\ &+ (\text{Pension Contribution Variance for year t}) \}, \\ &\text{divided by } 2 \text{ (two)} \\ &+ (\text{Closing Cumulative Capitalised Variances for year t-1} \times \text{Annual RPI Growth for year t}) \\ &\times \text{the cost of capital determined by the CAA for Oceanic for year t} \end{aligned}$$

$$\begin{aligned} \text{Net Capex Variance for year t} &= \text{Total Actual Net Capex for year t} \times \text{Within-year RPI Growth for year t} \\ &- \text{ERG's Assumed Net Capex for year t} \times \text{RPI Growth from 2003/04 for year t} \end{aligned}$$

ERG's Assumed Net Capex = For each financial year, figures are fixed at the following values in 2003/04 prices:

Financial year 2005/06: £4,691,990

Financial year 2006/07: £418,326

Financial year 2007/08: £655,625

Financial year: 2008/09: £1,104,723

Financial year 2009/10: £499,732

Financial year 2010/11: £404,980

$$\begin{aligned} \text{Closing Cumulative Capitalised Variances for year 2004/05 (i.e. year t-1 for the financial year 2005/06)} &= \text{£0 (zero)} \end{aligned}$$

Thereafter:

$$\begin{aligned} \text{Closing Cumulative Capitalised Variances for year t} &= \text{Closing Cumulative Capitalised Variances for year t-1} \times \text{Annual RPI Growth for year t} \\ &+ \text{Net Capex Variance for year t} \\ &+ \text{Pension Contribution Variance for year t} \\ &+ \text{Capitalised Financing Costs for year t} \end{aligned}$$

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The cost of capital determined by the CAA for Oceanic for year t = For each financial year, figures are fixed at the following values:

Financial year 2005/06: 8.00%

Financial year 2006/07: 6.75%

Financial year 2007/08: 6.75%

Financial year 2008/09: 6.75%

Financial year 2009/10: 6.75%

Financial year 2010/11: 6.75%

The amount of the RAB represented by Closing Cumulative Pension Contribution Variances for year t shall be identified in each year's regulatory accounts. The Closing Cumulative Pension Contribution Variances for year t shall be calculated in the same way as the Closing Cumulative Capitalised Variances for year t except disregarding the Net Capex Variance for year t.

5. Operating cost efficiency rolling incentive mechanism

The operating cost efficiency rolling incentive mechanism (RIM) provides an incentive for NERL to make continuing savings in its operating costs in UKATS and Oceanic throughout the second control period. The purpose is to encourage NERL to reveal a reduced cost base that can be reflected in price control calculations for the third control period and thereafter for the benefit of customers. CAA anticipates that operating cost projections for the third control period will be based on outturns for the last financial year available for that review, the penultimate year of the control period, 2009/10, which is designated as year 9 for this licence. The cumulative effect of operating cost out-performance revealed by year 9 is therefore the focus of this incentive mechanism. It operates by securing that the company is able to retain five years' worth of any incremental out-performance it is able to sustain up to year 9. The five-year duration of the control period will naturally secure that the company is able to retain five years' worth of incremental out-performance achieved in the first year of the control period, year 6. To secure an equivalent incentive to achieve further out-performance in later years, however, it is necessary to make an adjustment in the price control calculations for the following control period. CAA anticipates that it will effect the mechanism through an adjustment to the RABs, increasing the value of the RABs, at the start of the third control period.

CAA has adopted a four-step method:

- Step 1: identifies the level of outturn operating costs in applicable cost categories from regulatory accounting information;
- Step 2: calculates the level of out-performance that Step 1 data represent in comparison with CAA's assumptions for its price control calculations;
- Step 3: calculates for each year the incremental out-performance represented in Step 2 data; and
- Step 4: calculates the value of the adjustment to the RABs that is necessary to provide NERL with a full five-years' benefit for the incremental out-performance it has been able to deliver in years 7, 8 and 9.

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The following describes the formula for the adjustment to the RABs at 1 April 2011, which uses the results of the fourth step (O_4 for each relevant year), and the formulae and definitions for each of those steps (O_1 , O_2 , O_3 and O_4). The calculation of the adjustment will be made separately for UKATS and Oceanic.

RIM adjustment at 1 April 2011	=	The greater of ($O_{4, \text{year } 7} + O_{4, \text{year } 8} + O_{4, \text{year } 9}$) or £0
$O_{1, t}$ for years 6 to 9	=	x RPI Growth from 2003/04 for year 10 Operating costs in respect of year t attributable to UKATS and Oceanic respectively extracted or otherwise derived from NERL's regulatory accounts, excluding: bad debt costs; the costs of redundancies and major site staff relocations; pensions costs; any adjustment reducing operating costs in respect of allocations related to services provided by NERL to NSL; any profit or loss on disposal; depreciation, amortisation and impairment.
		multiplied by
		within-year RPI growth for year t
		divided by
		RPI Growth from 2003/04 for year t
$O_{2, t}$ for years 6 to 9	=	The greater of: ($O_{\text{ERG}, t} - O_{1, t}$) or £0
where $O_{\text{ERG}, t}$	=	For each financial year, figures are fixed at the following values for UKATS and Oceanic respectively:

	UKATS	Oceanic
Year 6 (financial year 2006/07):	£310,989,531	£14,603,317
Year 7 (financial year 2007/08):	£307,817,816	£14,503,766
Year 8 (financial year 2008/09):	£297,822,038	£14,418,403
Year 9 (financial year 2009/10):	£317,542,508	£14,334,944

Year 9 (financial year 2009/10):

$$O_{3,t} \text{ for years 7 to 9} = O_{2,t} - O_{2,t-1}$$

$O_{4,t}$ for years 7 to 9 = The discounted summation:

$$O_{3,t} \cdot \sum_{y=11}^{t+4} \frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})^{y-10}}$$

Namely:

$$O_{4, \text{year 7}} = O_{3, \text{year 7}} \cdot \left(\frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})} \right)$$

$$O_{4, \text{year 8}} = O_{3, \text{year 8}} \cdot \left(\frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})^2} + \frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})} \right)$$

$$O_{4, \text{year 9}} = O_{3, \text{year 9}} \cdot \left(\frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})^3} + \frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})^2} + \frac{1 + r_{CP3} \cdot 0.5}{(1 + r_{CP3})} \right)$$

where r_{CP3} = An annual discount rate consistent with the prospective cost of capital assessed by ERG, for UKATS and Oceanic respectively, for its price control calculations for the third control period

6. Pension pass-through methodology

Introduction

The following approach will be used to adjust the RAB in respect of the treatment of NERL pension costs for existing employees on a pass through basis:

- Split the planned pension cost between the amount related to existing employees and the amount related to new joiners to act as the baseline.
- In early 2006, identify the list of employees as at 1 January 2006 (the “existing employees”).
- Estimate a baseline of the planned actual cash pension costs for existing employees for each year of CP2.³
- Year by year, include the difference between the baseline and the actual cash pension cost for existing employees in the RAB.

³ This estimate will be fixed on the basis of information available in September 2005 on the expected “existing employees” for 1 January 2006.

Definition of Terms

The following definitions apply.

NERL pension cost	The cash pension cost relating to UKATS and Oceanic service lines, consistent with the basis of costs used for the regulatory price determination
Plan	Figures from NERL's 2005 Business Plan (V3 of the plan, model reference 050330 NATS v1320.xls), as used in the CAA's Firm Proposals dated May 2005.
Existing employees	Employees of the NATS Group who are members of the Pension Scheme as at 1 January 2006.
Baseline	The projected cash pension cost for existing employees derived from the Plan.
New joiners	Employees who join the Pension Scheme from 2 January 2006 onwards.

Deriving the baseline costs

The following projections show the baseline cash pension contributions for existing employees for each of UKATS and Oceanic.

ERG's assumed pension contributions for existing employees in 2003/04 prices (£)

	<u>2006/07</u>	<u>2007/08</u>	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>
UKATS	19,893,954	21,622,599	26,831,387	24,852,990	24,071,716
Oceanic	1,012,411	1,061,320	1,363,298	1,220,212	1,152,229

The projections have been prepared on a calendar year basis, as this is the normal basis for pay and pension modelling, and the results have been adjusted to a financial year basis.

The calculations have been prepared on a forecast outturn price basis, consistent with the inflation assumptions used in the NATS business plan. The results have been applied to the cash pension costs stated in 2003/04 prices.

The methodology used is to take the most up to date pension scheme membership list and project it forward over the period in line with the NATS business plan and then, for each year during CP2, to calculate the anticipated cash pension contribution for the existing employees projected still to be in service. The projection takes account of staff turnover and salary growth in line with the NATS business plan (or, in the absence of an assumption in the business plan, in line with the assumption used by the Scheme Actuary to CAAPS in the 31 December 2003 actuarial valuation), and applies the pension cash contribution rate used on the basis of actuarial advice in the business plan.

The results are adjusted to a financial year basis and the resulting allocation of baseline pension costs between existing employees and new joiners has been applied to the business plan projection of cash pension costs for UKATS and Oceanic to produce the

baseline cash pension cost for existing employees for each of UKATS and Oceanic.

Identifying the existing employees at 1 January 2006

As soon as possible after 1 January 2006, a list of all pension scheme members at 1 January 2006 will be compiled - including those in NATS, NERL and NSL. The staff number will be used as the key identifier.

The list will be retained for the duration of CP2.

Deriving the actual costs year by year

Total NERL pension costs on a cash basis will be extracted from the employee payments system. The calculations of actual costs for existing employees will be prepared on a financial year basis and will be derived as follows:

- Update the employee list to show existing employees still in service for part or all of the year, with a part year pro rata adjustment for leavers during the year such that the pensionable pay of existing employees is counted up to their date of leaving e.g. an existing employee who leaves on 30 September 2007 would have six months of their pay included in the calculation for the 2007/08 year.
- The NATS Group company to which the employee is seconded will be recorded. This will be defined by reference to the company to which the employee is seconded at the end of the financial year. This is needed to enable the relevant company allocation percentage to be applied to that employee's pension cost.
- Extract from the accounting system the actual annual allocation of company pension costs to NERL service lines for the year concerned.
- Extract the total pensionable pay for each employee during the year.
- Extract the actual cash contribution percentage paid by the company to the pension scheme. If the pension percentage changes mid-year (e.g. following the December 2007 valuation), a weighted average of the actual rates paid during the year will be used. For example, if the contribution percentage was x% from April to September and y% from October to March, the weighted average rate would be calculated as $(x\% + y\%) / 2$.
- Multiply pensionable pay x contribution percentage x company allocation percentage and sum across all employees to calculate total cash pension cost relating to existing employees.

The regulatory pass through is restricted to existing employees and existing benefits. Any augmentations or changes to benefits (apart from those arising from redundancies the cost of which are included separately in the business plan) resulting in a one off increase in the value of the liabilities or in a higher long term cost than would otherwise be the case would either result in:

- a reduction in the contribution percentage allowed for cash pass through, if the augmentation or benefit improvement is not paid for in cash by NATS. The amount of any reduction in the allowed plan percentage would be made on the basis of independent actuarial advice; or
- a higher actual cash contribution paid by NATS that would not be allowed in the cash pass through mechanism. The amount excluded would be made on the basis of independent actuarial advice; or

- a combination of the above two approaches, depending on the circumstances.

Application of pension costs for regulatory purposes

Pension costs are measured on a cash basis for regulatory price control purposes.

The total amount has been allowed in the price setting.

The difference between the baseline and actual cash pension cost for existing employees will be assessed annually. The annual differences will be rolled-forward to the end of CP2 and the cumulative difference for the whole of CP2 will be added to or subtracted from the RAB. The RAB will be reduced if the cumulative result indicates that actual cash costs are less than the baseline costs (after allowing for the roll-forward).

7. 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 made at the time of the Composite Solution in March 2003. 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 benchmark was established in March 2003.

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 was calibrated by the CAA at a benchmark level of 80% of NERL's cash-flows forecast at March 2003 for this period in net present value terms. These forecasts were taken to be those in the 'NATS base case', provided to the CAA in the form of a financial model;³
- 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 value equivalent of the RAB uplift will be the regulatory cost of capital assessed for UKATS over the relevant period; 7.75% pre-tax real for the first control period and the regulatory cost of capital, now established as 6.75%, 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 UKATS RAB in 2003/04 will count as 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:

³ NATS financial model v06

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$$\begin{aligned} \text{UKATS RAB clawback, 2011/12} &= \text{Appropriate deduction from UKATS RAB at the beginning of 2011/12 in 2001/02 prices} \\ &\times \text{RPI Growth from 2001/02 for 2010/11} \end{aligned}$$

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

$$\begin{aligned} \text{Appropriate deduction from UKATS RAB at the beginning of 2011/12 in 2001/02 prices} &= \text{The minimum of:} \\ &\text{£52.8 million (the present value in 2001 of the RAB uplift, in 2001/02 prices); or} \\ &\text{Maximum ((Total Actual NERL Cash-flow - Total Benchmark NERL Cash-flow) x 40\% clawback rate, 0)} \\ &\times (1+7.75\%)^5 \times (1 + 6.75\%)^5 \end{aligned}$$

The Total Actual NERL Cash-flow will be calculated as follows:

$$\begin{aligned} \text{Total Actual NERL Cash-flow} &= \sum_{t=\text{year } 3}^{\text{year } 9} \left\{ \frac{\text{NERL Cash - flows for year t in 2001/02 prices}}{\text{Mid - year Discount Factor for year t}} \right\} \\ &- \text{Closing 2002/03 UKATS plus Oceanic RABs divided by RPI Growth from 2001/02 for financial year 2002/03, divided by } (1+7.75\%)^2 \\ &+ \text{Closing 2009/10 UKATS plus Oceanic RABs divided by RPI Growth from 2001/02 for financial year 2009/10, divided by } ((1+7.75\%)^5 \times (1 + 6.75\%)^4) \end{aligned}$$

The NERL Cash-flows for year t in 2001/02 prices are to be calculated as follows:

$$\begin{aligned} \text{NERL Cash-flows for year t in 2001/02 prices} &= (\text{NERL's net cash-flow from operating activities in year t from the cash-flow analysis in NERL's audited regulatory accounts} \\ &- \text{NERL's net capital expenditure for year t from the cash-flow analysis in NERL's audited regulatory accounts}) \\ \text{Divided by} &\text{Mid-year Deflator to 2001/02 Prices for year t} \end{aligned}$$

The Mid-year Discount Factor for year t, for financial years 2003/04 to 2009/10, is calculated as follows.

$$\text{Mid-year Discount Factor for year t} = \text{the following defined amounts:}$$

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for years 3 to 5 (2003/04 to 2005/06)

$$\frac{(1 + 7.75\%)^t}{1 + (7.75\% \cdot 0.5)}$$

for years 6 to 9 (2006/07 to 2009/10)

$$\frac{(1 + 7.75\%)^5 \cdot (1 + 6.75\%)^{(t-5)}}{1 + (6.75\% \cdot 0.5)}$$

The calculation of the Total Benchmark NERL Cash-flow has been pre-determined by the CAA as follows:

$$\begin{aligned} \text{Total Benchmark NERL Cash-flow} &= \left[80\% \times \sum_{t=\text{year } 3}^{\text{year } 9} \left\{ \frac{\text{Benchmark NERL Cash - flows for year } t}{\text{Mid - year Discount Factor for year } t} \right\} \right] \\ &- \text{Forecast closing 2002/03 RAB discounted by 2 years at 7.75\%,} \\ &\quad \text{determined as £618.2 million} \\ &+ \text{Forecast closing 2009/10 RAB of £884.1 million} \\ &\quad \text{divided by } ((1+7.75\%)^5 \times (1 + 6.75\%)^4) \end{aligned}$$

The Benchmark NERL Cash-flows for year t are specified as follows:

Benchmark NERL Cash-flows for year t = the following amounts:

for year 3 (financial year 2003/04):	£ 91.6 million
for year 4 (financial year 2004/05):	£ 34.8 million
for year 5 (financial year 2005/06):	£ 93.7 million
for year 6 (financial year 2006/07):	£ 59.7 million
for year 7 (financial year 2007/08):	£ 70.8 million
for year 8 (financial year 2008/09):	£ 58.5 million
for year 9 (financial year 2009/10):	£ 70.0 million

The calculation of the Total Benchmark NERL Cash-flow can now be determined:

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Total Benchmark NERL Cash-flow	Defined amounts (01/02 prices)	Cost of capital	End-year discount factors	Mid-year Discount Factors	Multiplier	Total
Discounting for 2001/02	-	7.75%	1.078	1.037	-	-
Discounting for 2002/03	-	7.75%	1.161	1.118	-	-
Benchmark cash-flow for 2003/04	£91.6m	7.75%	1.251	1.204	0.8	£60.8m
Benchmark cash-flow for 2004/05	£34.8m	7.75%	1.348	1.298	0.8	£21.5m
Benchmark cash-flow for 2005/06	£93.7m	7.75%	1.452	1.398	0.8	£53.6m
Benchmark cash-flow for 2006/07	£59.7m	6.75%	1.550	1.500	0.8	£31.8m
Benchmark cash-flow for 2007/08	£70.8m	6.75%	1.655	1.601	0.8	£35.4m
Benchmark cash-flow for 2008/09	£58.5m	6.75%	1.767	1.709	0.8	£27.4m
Benchmark cash-flow for 2009/10	£70.0m	6.75%	1.886	1.824	0.8	£30.7m
less: forecast closing 2002/03 RAB (defined amount already discounted by 7.75% for two years)	-£618.2m		N/A	N/A	N/A	- £618.2m
plus: forecast closing 2009/10 RAB	£884.1m		1.886	N/A	N/A	£468.8m
Total Benchmark NERL Cash-flow (2001/02 prices)						£111.8m

The CAA expects NERL's published regulatory accounts to record explicitly the progress of this clawback arrangement 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 Sector⁴, 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.
 - (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

⁴ 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.

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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.