NATS (EN ROUTE) PLC REGULATORY ACCOUNTING GUIDELINES

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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 the UK Air Traffic Services Business and the En route (Oceanic) Business ("Oceanic") on a consistent basis, distinct from each other and its affiliate or related undertakings;

(b) assist the CAA to assess NERL's compliance with the Licence;

(c) assist the CAA and the public to assess 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 shall run from 1 April to the following 31 March unless otherwise agreed with the CAA.

4 Format and content of the regulatory accounts

4.1 The regulatory accounts will include the following statements which track NERL's performance against the CAA's regulatory determination:

- a comparison of performance of UK Air Traffic Services and Oceanic with the regulatory assumptions;
- a record of the movement in the UK Air Traffic Services and Oceanic regulatory asset bases, calculated in accordance with the basis used to set the price control for the quinquennium;
- a record of the incremental out-performance for the purpose of the operating cost efficiency roll forward for UK Air Traffic Services and Oceanic (section 5 of Annex 4); and
- a record of the actual and benchmark NERL cash flows for the purpose of the RAB clawback (section 7 of Appendix 3 of the CAA Decision).
- a record of actual traffic levels compared with the regulatory assumptions.

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

4.2 Proforma regulatory accounts are shown in Annex 3. The formulae for use in the statements tracking the regulatory asset base, regulatory out-performance and the cash flows for the purpose of the RAB clawback are set out in Annex 4.

4.3 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 to the regulatory accounts 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.

6 Allocations and Apportionments

6.1 The basis on which any amount has been either:

- charged from or to the UK Air Traffic Services Business and Oceanic together with a description of the basis of that charge; or
- determined by apportionment or allocation between the UK Air Traffic Services Business and Oceanic,

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 the UK Air Traffic Services Business and Oceanic 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

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.

<table>
<tr><th colspan="5">NERL</th></tr>
<tr><th colspan="4">UK Air Traffic Services</th><th rowspan="3">Oceanic</th></tr>
<tr><th colspan="3">En route (UK) Business</th><th rowspan="2">Other permitted business</th></tr>
<tr><th>Eurocontrol</th><th>North Sea Helicopters</th><th>London Approach</th></tr>
</table>

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)). Furthermore, as required by Condition 5, paragraph 12(b), the aggregate amount of all investments by NERL in the businesses described in paragraph 12(a)(v) must not at any time exceed 1% of the share capital in issue, share premium and consolidated reserves of NERL as shown by its most recent audited historic cost financial statements.

ANNEX 3: PROFORMA NERL REGULATORY ACCOUNTS

Contents

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

4. 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.

UK AIR TRAFFIC SERVICES

	UK Air Traffic Services					
	Current Year			Prior Year		
£ million						
	Actual	**CAA's CP2 Projection**	***Variance B/(W)***	**Actual**	**CAA's CP2 Projection**	***Variance B/(W)***
Eurocontrol revenue						
London Approach revenue						
Price controlled revenue						
Other income (Note 2)						
Intercompany income						
UKATS Revenue (including intercompany income)						
Operating costs (Note 3)						
Pension cash cost for existing employees (Note 4)						
Underlying depreciation (Note 5)						
Backlog adjustment to depreciation (Note 5)						
Total costs						
Regulatory profit						
CP1 Capitalised Financing Costs (Note 6)						
Capitalised Financing Costs for the year (Note 7)						
Regulatory return						
Average Regulatory Asset Base (RAB)						
Regulated rate of return (Note 8)						

ANALYSIS OF OTHER UKATS INCOME

£million	**Current Year**	**Prior Year**
North Sea Helicopters		
MoD		
Other external services		
Total		

NERL will include a statement about compliance with Condition 5, paragraph 12(a)(v) of the NERL Licence, that its external turnover of arising from the any other business as defined in the Licence does not exceed 3% of the aggregate turnover of the En route (UK) and En route (Oceanic) Businesses as defined in the Licence, and with Condition 5, paragraph 12(b), that the aggregate amount of all investments by NERL in the businesses described in paragraph 12(a)(v) has not at any time exceeded 1% of the share capital in issue, share premium and consolidated reserves of NERL as shown by its most recent audited historic cost financial statements.

OCEANIC

£ million	2006/07			2005/06		
	Actual	**CAA's CP2 Projection**	***Variance B/(W)***	**Actual**	**CAA's CP2 Projection**	***Variance B/(W)***
Shanwick Oceanic Control Area charges						
Other revenue (Note 2)						
Total revenue				21.6	21.3	*0.3*
Operating costs (Note 3)				14.4	15.7	*1.2*
Pension cash cost for Existing Employees (Note 4)				1.1	1.1	*0.1*
Depreciation (Note 5)				1.2	1.2	-
Total costs				16.7	18.0	*1.3*
Regulatory profit				**4.9**	**3.3**	***1.5***
CP1 Capitalised Financing Costs (Note 6)				0.5	0.5	-
Capitalised Financing Costs for the year (Note 7)				0.0	-	*0.0*
Regulatory return				**5.4**	**3.8**	***1.5***
Average RAB				22.5	22.8	*(0.3)*
Regulated rate of return (Note 8)				**23.95%**	**16.84%**	***7.11%***

CHARGES TO NERL FROM OTHER GROUP COMPANIES

£million	**Current Year**	**Prior Year**
Charges from NATS Ltd		
Charges from NATS (Services) Ltd		
Total		

Notes

1. Performance is compared with the projection for CP2 included in the CAA's Decision (December 2005).
2. In the case of UK Air Traffic Services, Price Controlled Revenue is the revenue for Eurocontrol and London Approach, and Other Income is other external income included within UK Air Traffic Services; it is analysed in the table above. In the case of Oceanic, Other Income is any income other than income from the Shanwick Oceanic Control Area charges.
3. Operating costs:

- For the purposes of the price control, operating costs (which are derived from the statutory accounts and are on an accounting basis except where otherwise stated) are stated excluding accounting depreciation, accounting pension costs, and profit/loss on disposal of assets. The disposal of assets is dealt with through the Regulatory Asset Base (RAB), rather than in the performance statement. For pensions and depreciation, see notes 4 and 5 below.
- Operating costs include charges from other group companies; these charges to NERL, from NATS Ltd and NATS (Services) Ltd, are detailed in the table above. If NERL receives charges for services from any other subsidiary, in addition to those from NATS (Services) Ltd, these will be added into the table.
- Operating costs are stated after deducting capitalised internal labour costs. The regulatory accounts will include a statement of the actual amount for each of UK Air Traffic Services and Oceanic, compared with the amounts assumed in the CAA projections. The amounts included in the CAA CP2 projections are shown in the table on the following page.
- From 2006/07 onwards, operating costs include cash pension costs for New Joiners (see note 4 below).

4. NERL's cash pension costs are added back in.
    - For Existing Employees (as defined in the pension cost pass through) the cash pension cost is shown separately on the face of the table. The CAA's assumption on cash pension costs for Existing Employees is included in the Actual column of the Regulatory Performance Statement because the variance between the actual and CAA's assumed cash pension cost for Existing Employees is dealt with through the RAB.
    - For New Joiners (as defined in the pension cost pass through), where the company bears the risks of variations from the regulatory assumptions, the actual cash pension cost incurred by the company is included in the general operating cost figure.
    - The CP2 pension arrangements came into effect for 2006/07 onwards; therefore the figure for 2005/06 is not analysed between Existing Employees and New Joiners and instead it is stated as in the regulatory accounts for 2005/06.
5. The CAA's allowed regulatory depreciation is shown separately on the face of the table. In the case of UKATS, the CAA's allowed depreciation comprises underlying depreciation and the CAA's backlog adjustment to depreciation.
6. The CP1 capitalised financing cost is the amount in respect of CP1 as calculated by the CAA during the CP2 price review and is added to the RAB in the 2005/06 accounts for the start of CP2.
7. Capitalised financing costs for the year in respect of the capital expenditure variance and the pension contribution variance are added to the RAB to enable remuneration in future review periods. These financing costs are added to the regulatory profit for the calculation of the regulatory return.
8. The rate of return in the CAA's projection column for the years in CP2 averages to the allowed rate of return over CP2. The profile of the returns year by year within CP2 will be shown in the regulatory accounts.

	2005/06	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**
UKATS	12.33%	10.03%	6.47%	5.00%	3.90%	6.23%
Oceanic	16.84%	7.52%	7.30%	3.56%	6.80%	7.69%

The derivation of these numbers is shown in the table below.

9. The amounts are stated in terms of average prices for the year. Hence some of the figures are slightly different from those in section 5 (the RAB) which are at year-end prices.
10. Any small differences in these schedules are due to rounding. Given the nature and

purpose of these schedules, it is not considered appropriate to eliminate the rounding differences.

CAA'S CP2 PROJECTIONS

£'000 in 2003/4 prices (CHAW=182.5)	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
UKATS Regulatory Performance Statement						
Eurocontrol income	445,380	440,046	436,255	432,811	431,829	435,485
London Approach income	8,014	8,014	8,023	8,197	8,476	8,833
Price control income	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	515,563	506,865	501,482	497,031	495,530	499,360
Operating costs (Note 1)	-318,962	-328,060	-335,642	-332,475	-338,679	-315,736
Pension cash cost for Existing Employe	-20,755	-19,894	-21,623	-26,831	-24,853	-24,072
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
Regulatory profit	84,426	86,821	61,561	48,839	37,278	57,920
Capitalised Financing Costs	11,369	0	0	0	0	0
Regulatory return	95,794	86,821	61,561	48,839	37,278	57,920
Average RAB	776,694	866,011	952,143	976,379	956,640	929,990
Regulated rate of return	12.33%	10.03%	6.47%	5.00%	3.90%	6.23%
Oceanic Regulatory Performance Statement						
Oceanic Revenue	20,173	20,135	20,076	20,024	19,951	19,917
Operating costs (Note 1)	-14,796	-14,974	-14,928	-15,396	-14,853	-14,839
Pension cash cost for Existing Employe	-1,081	-1,012	-1,061	-1,363	-1,220	-1,152
Depreciation	-1,142	-2,364	-2,418	-2,510	-2,552	-2,586
Regulatory profit	3,154	1,785	1,669	755	1,326	1,340
Capitalised Financing Costs	474	0	0	0	0	0
Regulatory return	3,627	1,785	1,669	755	1,326	1,340
Average RAB	21,543	23,746	22,862	21,235	19,510	17,424
Regulated rate of return	16.84%	7.52%	7.30%	3.56%	6.80%	7.69%

Note 1: Operating costs includes the cash pension cost for New Joiners as defined in the Pension Cost Pass Through Methodology (RAGs, Annex 4, Section 6)

£'000 in 2003/4 prices (CHAW=182.5)	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Capitalised internal labour costs included in the CAA CP2 projections						
UK Air Traffic Services	20,999	20,723	14,551	11,682	12,974	10,845
Oceanic	903	36	79	218	116	133

5. MOVEMENT IN THE REGULATORY ASSET BASES

The definitions and formulae for the rolling forward of the UKATS and Oceanic Regulatory Asset Bases (RABs) 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 :

	UK Air Traffic Services					
	Current Year			**Prior Year**		
£ million						
	Actual	**CAA's projection**	***Variance***	**Actual**	**CAA's projection**	***Variance***
Opening RAB as at 1 April in opening prices						
The figures below are all at year end prices						
Opening RAB restated at year end prices						
plus total capital expenditure at year end prices (Note 2)						
plus pension contribution variance (Note 3)						
plus CP1 capitalised financing costs (Note 4)						
plus capitalised financing costs for the year (Note 5)						
minus CAA’s allowed underlying depreciation (Note 7)						
add back CAA's backlog adjustment to allowed depreciation (Note 8)						
plus increase/(decrease) in working capital (Note 9)						
Closing RAB as at 31 March						

See notes below.

(£ million)	Oceanic					
	Current Year			Prior Year		
	Actual	CAA's projection	*Variance*	Actual	CAA's projection	*Variance*
Opening RAB as at 1 April in opening prices						
The figures below are all at year end prices						
Opening RAB restated at year end prices						
plus total capital expenditure at year end prices (Note 2)						
plus pension contribution variance (Note 3)						
plus CP1 capitalised financing costs (Note 4)						
plus capitalised financing costs for the year (Note 5)						
plus CP1 rolling incentive adjustment (Note 6)						
minus CAA's assumed ordinary depreciation charge (Note 7)						
plus/minus increase/(decrease) in working capital (Note 9)						
Closing RAB as at 31 March						

Notes

1. The CAA projections are shown below; further detail is provided in Annex 4.
2. Capital expenditure for the purpose of this table is expenditure on property, plant and equipment. It includes expenditure on fixed assets required under IFRS to be reclassified from tangible to intangible (principally software and assets relating to airspace resectorisation projects). It is stated net of proceeds of disposal and grants and other contributions to fixed assets. The RAB excludes any NERL capital expenditure on the Height Monitoring Unit as it is remunerated outside the price control.
3. The pension contribution variance measures the difference between actual cash pension contributions for Existing Employees and the amount assumed by the CAA when setting the price control. The table below records the cumulative pension contribution variance included in the RAB at each year end.
4. The CP1 capitalised financing cost is the amount in respect of CP1 as calculated by the CAA when setting the CP2 price control and is added to the RAB in 2005/06 for the start of CP2.
5. Capitalised financing costs for the year in respect of the capital expenditure and pension contribution variances are added to the RAB to enable remuneration in future review periods.
6. An adjustment is added to the Oceanic RAB in 2006/07 for the out-performance against the rolling incentive mechanism in CP1.
7. The RAB is reduced by the allowed depreciation assumed in the price control, not by accounting depreciation.
8. In the case of UK Air Traffic Services, the CAA included a backlog adjustment to the amount of depreciation it allowed in setting the price control. This amount adjusts for the difference

between the depreciation allowed during CP1 (including the price profiling adjustment) and what depreciation would have been based on actual capital expenditure in CP1.

9. Working capital for RAB purposes is defined as debtors and creditors, accruals and prepayments arising from trading (including transactions in respect of attributable fixed assets). It excludes any amounts relating to financing, tax, distributions and pension contributions.

10. Any small differences in these schedules are due to rounding. Given the nature and purpose of these schedules, it is not considered appropriate to eliminate the rounding differences.

CAA PROJECTIONS OF RAB MOVEMENTS

£'000 in 2003/4 prices (CHAW=182.5)	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
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	809,115	922,906	981,380	971,378	941,901	918,078
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	23,734	23,759	21,965	20,505	18,514	16,333

CLOSING CUMULATIVE PENSION CONTRIBUTION VARIANCE

At 31 March **£ million in outturn prices**	**2007**	**2008**	**2009**	**2010**	**2011**
UK Air Traffic Services					
Oceanic					

Note: the closing cumulative pension contribution variance is the cumulative value of the pension contribution variances over CP2. At each year end, it is calculated in accordance with the formulae in the Regulatory Accounting Guidelines and is stated at year end prices.

6 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.

(£ million, 2003/04 prices)	**2006/07**	**2007/08**	**2008/09**	**2009/10**
UK Air Traffic Services				
Operating expenditure assumed by CAA	311.0	307.8	297.8	317.5
Actual operating expenditure				
Out-performance				
Incremental out/(under)-performance compared with previous year	n/a			
Oceanic				
Operating expenditure assumed by CAA	14.6	14.5	14.4	14.3
Actual operating expenditure				
Out-performance				
Incremental out/(under)-performance compared with previous year	n/a			

Note for information: actual operating costs at outturn (actual) prices

(£ million)	**2006/07**	**2007/08**	**2008/09**	**2009/10**
UK Air Traffic Services				
Oceanic				

Notes

1. The definition of operating costs for the purposes of the operating cost efficiency rolling incentive mechanism is the operating cost from the Regulatory Performance statement less: bad debt costs, the costs of major site redundancies and major site staff relocations, and pension costs. In the case of Oceanic, and consistent with the basis used in the CAA projections, operating costs excludes the costs relating to the Height Monitoring Unit as these are remunerated outside the price control.
2. Any small differences in these schedules are due to rounding. Given the nature and purpose of these schedules, it is not considered appropriate to eliminate the rounding differences.

7 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 is shown below. The present value of the Total Benchmark NERL cash flow, at 2001/02 prices, is £111.8m (see Annex 4, section 7).

(£ million)	31 March 2003	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	31 March 2010
ACTUAL DATA									
Actual figures from the regulatory accounts									
UK Air Traffic Services RAB at 31 March 2003	725.5								
UK Air Traffic Services RAB at 31 March 2010									
Oceanic RAB at 31 March 2003	13.6								
Oceanic RAB at 31 March 2010									
Total RAB at 31 March 2003 and 31 March 2010	739.1								
NERL cash flows:									
Cash generated from operations		194.8	246.1	233.6					
less: cash flow from purchase of fixed assets		-80.7	-108.2	-152.3					
Total NERL actual cash flow		114.1	137.9	81.3	0.0				
Actual figures at 2001/2 prices									
RAB at 31 March 2003	-714.5								
Annual cash flow		108.7	127.4	73.2					
Present values (discounted using regulatory cost of capital to 1 April 2001 values)									
RAB at 31 March 2003 and 31 March 2010	-615.4								884.1
Annual cash flow		90.3	98.2	52.4					
BENCHMARK DATA									
RAB at 31 March 2003 and 31 March 2010 (as stated in CAA Decision, discounted to 1 April 20	-618.2								468.8
NERL's forecast base case cash flows in 2001/2 prices		91.6	34.8	93.7	59.7	70.8	58.5	70.0	
Present value of NERL's forecast base case cash flows (2001/2 prices)		76.1	26.8	67.0	39.8	44.2	34.2	38.4	
Benchmark: 80% of NERL's forecast base case cash flows in present value terms (2001/2 prices)		60.8	21.5	53.6	31.8	35.4	27.4	30.7	
Note: discount factor back to 1 April 2001 present	*1.161*	*1.204*	*1.298*	*1.398*	*1.500*	*1.601*	*1.709*	*1.824*	*1.886*

8. RECORD OF THE RETAIL PRICE INDICES USED IN THE REGULATORY CALCULATIONS

	1999/ 2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Average for year/mid year	166.4	171.3	173.9	177.5	182.5	188.2	193.1	
At 31 March (year end)	n/a	172.2	174.5	179.9	184.6	190.5	195.0	

This table will be added to year by year.

9. RECORD OF TRAFFIC LEVELS COMPARED WITH THE REGULATORY ASSUMPTIONS

UKATS

	CSU (000s)		Distance (chargeable kilometres, millions)	
Calendar Year	CAA assumption	Actual	CAA assumption	Actual
2006	10,015	10,269	741	763
2007	10,198		756	
2008	10,504		776	
2009	10,876		798	
2010	11,293		823	
Financial Year				
2006/07	10,071		745	
2007/08	10,279		761	
2008/09	10,578		780	
2009/10	10,975		804	
2010/11	11,389		829	

Oceanic

	Flights	
Financial year	CAA assumption	Actual
2006/07	390,900	
2007/08	406,000	
2008/09	421,800	
2009/10	437,300	
2010/11	454,200	

ANNEX 4: FORMULAE FOR TRACKING THE REGULATORY ASSET BASE

Note: this annex is based on Appendix 3 from "NATS Price Control Review 2006-2010, CAA Decision" (December 2005).

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[1], equals 182.5.

[1] 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:

Closing RAB for financial year 2004/05 (i.e. at 31 March 2005)	=	£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):

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
+		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) derived from the audited statutory accounts,

− the proceeds of disposals of UKATS tangible fixed assets in year t derived from the audited statutory accounts,

− any grants or other contributions (e.g. customer contributions) to UKATS fixed assets for year t derived from the audited statutory 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 UKATS working capital (in outturn prices) at the end of year t derived from the statutory 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	

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:

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):

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) derived from the audited statutory accounts, − the proceeds of disposals of Oceanic tangible fixed assets in year t derived from the audited statutory accounts, − any grants or other contributions (e.g. customer contributions) to Oceanic fixed assets for year t derived from the audited statutory 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 statutory 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 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

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 Oceanic 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: 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
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 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.

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 x RPI Growth from 2003/04 for year 10
$O_{1,\,t}$ for years 6 to 9	=	Operating costs in respect of year t attributable to UKATS and Oceanic respectively extracted or otherwise derived from NERL's statutory 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: ($O_{ERG,\,t} - O_{1,\,t}$) or £0
where $O_{ERG,\,t}$	=	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

$O_{3,\,t}$ 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:

$O_{4,\text{ year 7}}$ =

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

$O_{4,\text{ year 8}}$ =

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

$O_{4,\text{ year 9}}$ =

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

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 cost 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.[2]
- Year by year, include the difference between the baseline and the actual cash pension cost for existing employees in the RAB.

[2] 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 (£)

	2006/07	2007/08	2008/09	2009/10	2010/11
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

UKATS RAB clawback, 2011/12 = Appropriate deduction from UKATS RAB at the beginning of 2011/12 in 2001/02 prices

X RPI Growth from 2001/02 for 2010/11

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

Appropriate deduction from UKATS RAB at the beginning of 2011/12 in 2001/02 prices = The minimum of:
£52.8 million (the present value in 2001 of the RAB uplift, in 2001/02 prices); or
Maximum ((Total Actual NERL Cash-flow − Total Benchmark NERL Cash-flow) x 40% clawback rate, 0)

X $(1+7.75\%)^5 \times (1 + 6.75\%)^5$

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

Total Actual NERL Cash-flow =

$$\sum_{t=year\ 3}^{year\ 9} \left\{ \frac{\text{NERL Cash - flows for year t in 2001/02 prices}}{\text{Mid - year Discount Factor for year t}} \right\}$$

− Closing 2002/03 UKATS plus Oceanic RABs divided by RPI Growth from 2001/02 for financial year 2002/03,
divided by $(1+7.75\%)^2$

+ Closing 2009/10 UKATS plus Oceanic RABs divided by RPI Growth from 2001/02 for financial year 2009/10,
divided by $((1+7.75\%)^5 \times (1 + 6.75\%)^4)$

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

NERL Cash-flows for year t in 2001/02 prices = (NERL's net cash-flow from operating activities in year t from the cash-flow analysis in NERL's audited statutory accounts

− NERL's net capital expenditure for year t from the cash-flow analysis in NERL's audited statutory accounts)

Divided by Mid-year Deflator to 2001/02 Prices for year t

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

Mid-year Discount Factor for year t = the following defined amounts:

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:

Total Benchmark NERL Cash-flow =

$$\left[80\%\times\sum_{t=\text{year }3}^{\text{year }9}\left\{\frac{\text{Benchmark NERL Cash - flows for year t}}{\text{Mid - year Discount Factor for year t}}\right\}\right]$$

− Forecast closing 2002/03 RAB discounted by 2 years at 7.75%, determined as £618.2 million

+ Forecast closing 2009/10 RAB of £884.1 million divided by $((1+7.75\%)^5 \times (1 + 6.75\%)^4)$

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:

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, including the requirement that the NERL regulatory accounts should be prepared according to accounting policies that are consistent with the basis of the determination values used by the CAA when setting the price control unless the CAA consents to a change. 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) All costs are allocated to Services.

(b) Where costs relate wholly to one Service, they will be driven direct to that Service.

(c) For costs which do not relate wholly to one Service, where appropriate, a market test approach will be adopted, based on establishing market prices by open tender or by comparison with published list prices. However, it is recognised that market based charging will not be possible for most internal NATS group transactions for some time. Therefore the approach will be based on cost allocation, as far as possible based on drivers which are appropriate and quantifiable drivers of the cost.

(d) Where possible, costs related to associated activities or assets will be grouped together and allocated on a common basis.

(e) Where a secondary user has the benefits of a facility or activity, costs will be allocated using the most appropriate basis, recognising that:

(i) 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.

(ii) 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.

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

1.3 In the case of transactions with other group companies:

(a) In the case of services traded between NERL and other group companies, these are carried out at an agreed price. Inter company prices are set by reference to market prices where such prices exist and are appropriate, and otherwise by reference to the costs of the activities performed, as determined above.

(b) Management services – which are provided by NATS Ltd to NERL and NSL and by NERL to NSL - are charged at cost to activities in the recipient company, for recovery of the costs from external customers.

2. PROCESS

2.1 Cost allocations are carried out using activity based costing principles which are applied in a two stage process:

(a) Costs are booked or attributed to the activities or tasks they perform;

(b) The costs of activities are allocated to the services provided to customers.

2.2 Fixed assets are allocated following the same principles that are applied to operating costs.