



AN AD HOC REVIEW OF NATS RELATED RISKS

INTERIM REPORT

September 2012

Civil Aviation Authority
CAA House, 45-59 Kingsway, London WC2B 6TE

Summary

- S1. The provision of a safe, efficient and sustainable en route air navigation service by a licence holder is essential for the CAA being able to further the interests of airspace users and meet its other duties and obligations under legislation be that at the European or national level.
- S2. There are a number of trends and future challenges that make it timely for the CAA to review its regulation of the current licence holder, NATS (En Route) plc (NERL). These trends and future challenges include:
- forecasts for long-term traffic and congestion. The CAA has a high level of assurance about NERL's safety competence and Safety Management System (SMS), but increasing congestion may challenge traditional approaches to safety management;
 - NATS through its subsidiary NATS (Services) Limited (NSL) aiming to develop significantly its business outside its en route monopoly. This may create or accentuate indirect risks for NERL;
 - NERL taking an increasingly commercial view in its provision of regulated services. This may necessitate greater clarity from the CAA on the scope of these services;
 - the ongoing development of the Single European Sky (SES) programme. This is expected to challenge NERL's performance expectations, especially in terms of its cost-efficiency; and
 - the prospect of changes in ownership of NATS and/or NERL. As this is something that the CAA cannot control it is important it ensures as far as possible that its regulation is not dependent on a particular form of ownership or ownership structure.
- S3. To ensure consistency with the government's Better Regulation Principles regulators should periodically review their frameworks. In doing so regulators should have in mind the need for their frameworks to be targeted, proportionate, consistent, transparent and accountable. The CAA has undertaken a short high-level review of the strategic outcomes it wishes to secure through its regulation of NERL over the next few years. The CAA has then assessed the potential risks that

might frustrate its ability to secure these strategic outcomes. Finally, it has evaluated the most proportionate way to mitigate these risks.

- S4. The CAA's initial views are contained within this Interim Report. It includes 12 draft recommendations on which stakeholder feedback is welcome. Broadly speaking, many of the risks identified can be mitigated, but not eliminated, through the CAA taking a different approach to its use of regulatory levers. For example, there are a number of areas where more proactive scrutiny by the CAA of NERL's business plans may be desirable. There may also be a number of areas where further clarity or evolution in the NERL licence conditions may help provide the CAA and users with greater assurance.
- S5. The CAA would welcome stakeholders' views on this Interim Report by **19 October 2012**. Views are especially welcome from stakeholders on whether:
- the CAA's draft strategic outcomes for its regulation of NERL are appropriate; and
 - the CAA's draft recommendations represent a targeted and proportionate set of responses best designed to help the CAA achieve the draft strategic outcomes and mitigate potential risks.
- S6. Following careful consideration of responses to this Interim Report and further discussion with stakeholders the CAA expects to publish a Final Report early in the New Year.
- S7. The outcome of the CAA's Final Report could set objectives and context for more detailed CAA work programmes such as its approach to safety oversight, its implementation of the Future Airspace Strategy (FAS), and its work required under the second reference period of the EU Performance Scheme (2015-2019), which will include the setting of the next NERL price control. If the CAA's Final Report concludes that there is merit in modifying NERL's licence, the CAA will subsequently formally consult stakeholders.
- S8. The CAA aims to take a risk-based approach to its regulation of NERL. The CAA has not reviewed every aspect of its regulation and relationship with NERL. Nor is it possible or proportionate to forecast every possible trend and risk that might arise. There is a balance to be struck between the timeliness of this ad hoc review and its

coverage and depth. The CAA will keep its regulatory framework under review and will respond proportionately as new information comes to light that affects the risk environment for its regulation of NERL.

CAA September 2012

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1. Introduction

(a) Terms used in this document

- 1.1. References to NATS relate to NATS Holdings Limited, which is the ultimate parent company of the NATS group of companies. References to NERL or the regulated business relate to NATS (En Route) plc, which holds a licence for provision of en route services under the Transport Act 2000 (the Act). The prices NERL can charge users and certain quality standards, such as its capacity/delay performance, are subject to economic regulation by the CAA. References to NSL relate to NATS (Services) Limited, which is a subsidiary of NATS that provides air navigation services at airports in the UK and other countries. The CAA regulates NSL's safety in the UK but not the prices and quality of its services. All providers of air navigation services at airports are exempt from economic regulation under the Act.
- 1.2. Annex I contains a glossary of terms used in this document.

(b) Purpose of this review

i. Motivation for the CAA's review

- 1.3. As the UK's monopoly en route provider NERL is critical to the provision of a safe, efficient and sustainable air traffic service. The CAA must have a strategic approach to its relationship with, and regulation of, NERL. The relationship with NERL cuts across a number of the CAA's functions including safety regulation, airspace policy and economic regulation. NSL is also a significant provider of air navigation services at airports in the UK.
- 1.4. A number of issues in relation to NERL and NSL have been recently discussed internally within the CAA. These include:
 - passengers' interests in the longer term in relation to a safe, efficient and sustainable air navigation system;
 - NSL's business strategy;
 - the role and appetite of NERL in delivering the FAS;
 - the government's recent consultation on whether to sell all or part of its equity holding in NATS and the potential for changes initiated by other NATS shareholders;
 - the European Commission Performance Review Body's assessment of the UK National Performance Plan (NPP) and in particular its criticisms of NERL's cost-efficiency;
 - NERL's obligations with respect to certain Specified Services required to be provided by its licence;

- NERL's licence obligations in relation to prioritising airspace demands during the London Olympics; and
 - NERL's recent refinancing of its debt facilities.
- 1.5. These issues taken together, rather than in isolation, have prompted the CAA Board to establish an ad hoc group of its members to undertake a focused review of future NATS related risks and whether the CAA has adequate regulatory levers to tackle these risks.
- 1.6. In undertaking this review the CAA is mindful of regulatory best practice. This calls for regulators to periodically review their frameworks to ensure they remain targeted, proportionate, consistent, transparent and accountable.

ii. Terms of reference

- 1.7. The terms of reference for the ad hoc CAA Board review were approved by the CAA Board in March 2012. The main focus of the review is the CAA's regulation of NERL, the en route regulated business. However, the review is also interested in other activities of NATS to the extent that they either create risks for NERL or are NATS businesses that have a role to play in the CAA meeting its various duties under UK and EU legislation.

Figure 1.1: Summary of the terms of reference for the ad hoc CAA Board review

- To provide assurance to the CAA Board on the strategic shape and direction of the CAA's relationship with, and regulation of, NATS including:
 - consumer, strategic and business risks associated with the CAA's regulation of NERL;
 - CAA responses to changes in the NATS risk environment; and
 - robustness of NERL's licence as a key vehicle of regulation.
- Focus on strategic objectives not tactical steers.
- Review undertaken by a task and finish group of CAA Board members chaired by David Gray.
- Board group supported by CAA's NERL Licence Management Coordination Committee (NLMCC) comprising senior staff from the CAA groups most involved in the regulation of NERL.
- Interim Report to CAA Board in July 2012 and Final Report to CAA Board in December 2012.

Source: CAA

- 1.8. Core membership of the ad hoc CAA Board group comprises:
- David Gray, Chair of the ad hoc Board review group and Non Executive Director
 - Andrew Haines, Chief Executive

- Gretchen Haskins, Group Director, Safety Regulation
- Iain Osborne, Group Director, Regulatory Policy
- Mark Swan, Group Director, Airspace Policy

1.9. The CAA's ad hoc Board group is supported in its work by members of the CAA's NERL Licence Management Coordination Committee (NLMCC) in addition to other staff. The CAA's NLMCC includes:

- Richard Moriarty, Secretary to the CAA's ad hoc Board group and Director of Economic Regulation
- Kirsten Riensema, Head of Aerodrome and Air Traffic Safety Standards
- Phil Roberts, Assistant Director, Airspace Policy
- Dave Snowden, Air Traffic Safety Standards
- David Stoplar, Legal Adviser

(c) Methodology for the CAA's review

1.10. The review is structured into four broad phases. The CAA's initial views on each phase are contained in this Interim Report.

- Phase I – the identification of future trends and challenges in the regulatory operating environment. This horizon-scanning process has focused on the period leading up to 2020 (and in some cases beyond). This coincides with the next Reference Period (RP2) for the Performance Scheme under SES.
- Phase II – the articulation of a number of strategic outcomes for the CAA's future regulation of NERL. The CAA will need assurance from this review that it has adequate regulatory levers to deliver these strategic outcomes.
- Phase III – a 'gap analysis' of potential future risks and current and possible regulatory levers to mitigate these risks.
- Phase IV – the development of draft recommendations for the CAA in line with the government's Better Regulation Principles. These recommendations may shape the objectives of future CAA work programmes, such as the next price control review for NERL under the EU Performance Scheme, FAS implementation and safety oversight and assurance.

(d) Next steps

1.11. The CAA intends to publish its Final Report from this review early in the New Year.

1.12. The CAA wishes to be transparent in undertaking this review. It will undertake targeted and informal consultation with key stakeholders. Should the conclusions of this review lead the CAA to consider proposing modifications to the NERL licence, then the CAA will undertake the required consultation with interested parties at that

point. The CAA would normally expect any changes that have an effect on the value or risk of NERL's future cash flows to be considered alongside the work the CAA will need to undertake for its review of the NERL price control.

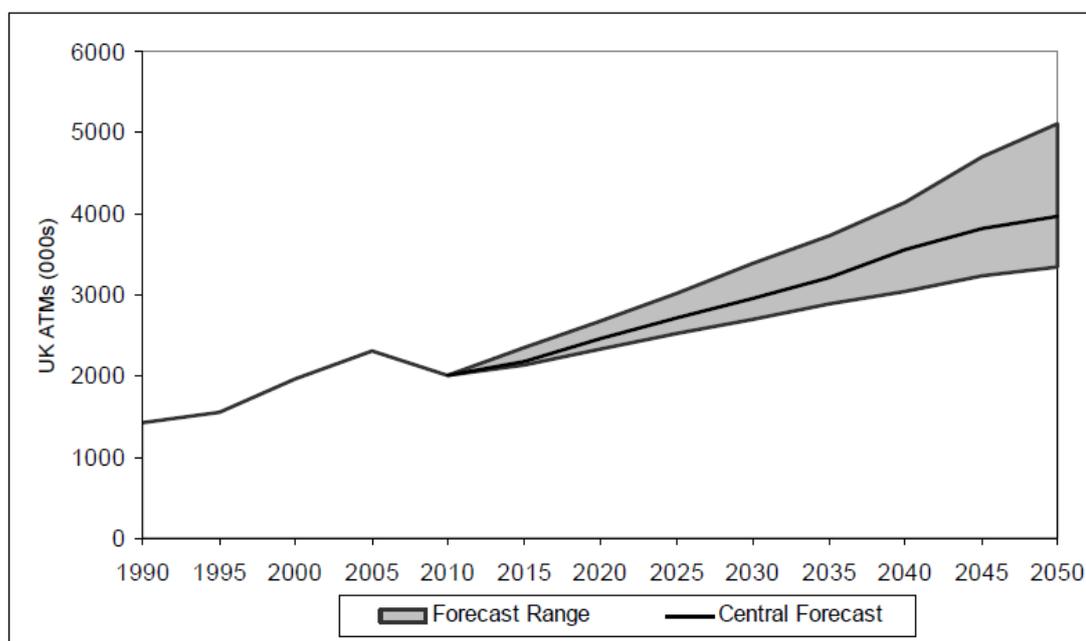
- 1.13. Views are especially welcome from stakeholders on whether:
- the CAA's draft strategic outcomes for its regulation of NERL are appropriate; and
 - the CAA's draft recommendations represent a targeted and proportionate set of responses best designed to help the CAA achieve the draft strategic outcomes and mitigate potential risks.
- 1.14. Should you wish to discuss any aspect of this Interim Report with the CAA please contact Richard Moriarty on 020 7453 6203 or at richard.moriarty@caa.co.uk.
- 1.15. Written representations should be sent by **19 October 2012** to barbara.peratasmith@caa.co.uk. The CAA will acknowledge all responses. It expects to make responses available on its website for other interested parties to read as soon as practicable after 19 October 2012. Any material that stakeholders regard as confidential in their written representations should be clearly marked or included in a separate annex which, subject to the criteria the CAA has established for treating information as confidential, will not be published.

2. Trends and challenges for the future regulatory environment

(a) Long-term traffic trends and technology changes will challenge established approaches to air navigation safety management

2.1. The Department for Transport (DfT) forecasts indicate that air traffic movements at major airports in the UK will increase by 1.9% per year to grow from 2 million in 2010 to 3.2 million by 2035. This will increase the congestion pressures on UK airspace. Airspace in and around London is already some of the most complex in Europe.

Figure 2.1: Long-term traffic projections



Source: UK Aviation Forecasts: DfT: August 2011
(N.B. Forecasts for the UK's largest 31 airports. Excludes projections for en route over-flights)

- 2.2. The traditional air traffic management (ATM) approach to dealing with greater congestion is to sub-divide airspace into smaller sectors and use more air traffic controllers to manage these sub-sectors. Over time NERL has undertaken successive processes of 're-sectorisation' to en route airspace in a safe and controlled way, although it has also started to deploy new technologies as well such as iFACTS.
- 2.3. Although this approach has served en route airspace users well to date it is likely to prove inadequate to meet the challenges of the future in terms of long-term traffic growth and congestion trends. This approach is likely to experience diminishing returns as traffic and congestion continue to grow.

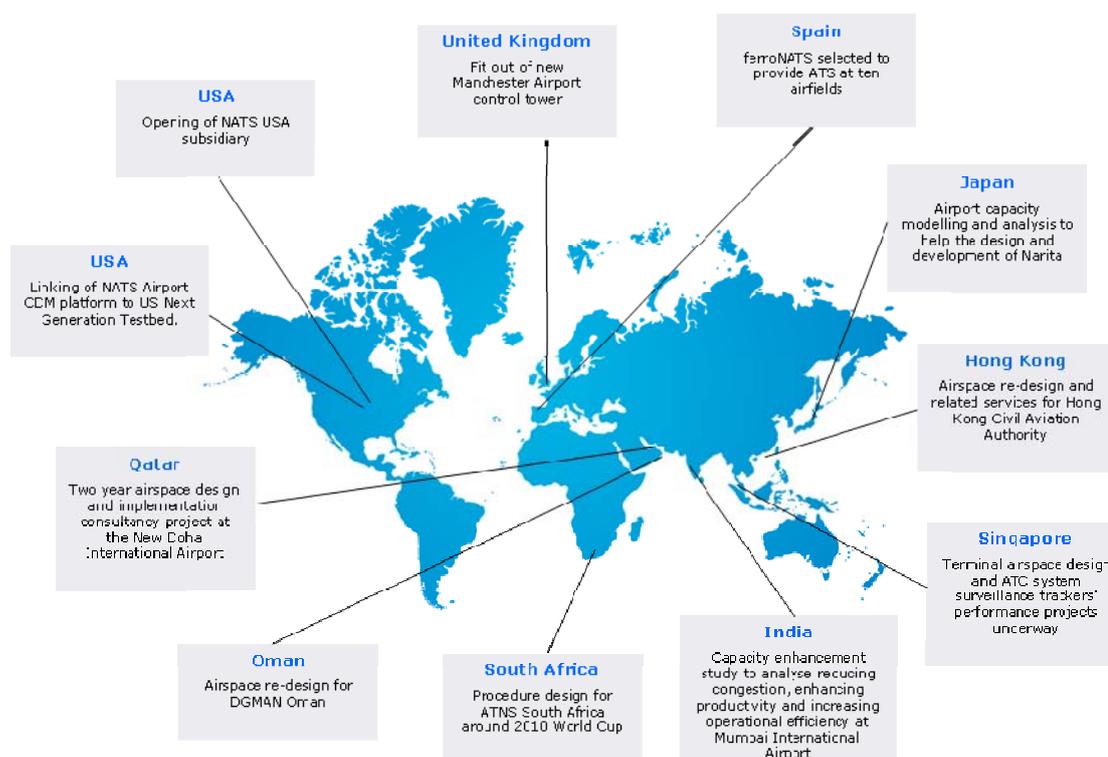
2.4. This challenge is coupled with a likely shift in the future direction of technology used to support the provision of air navigation services. In particular, the technologies envisioned by the Single European Sky Air Traffic Management Research Programme (SESAR) and further articulated in the FAS, will evolve the role of the air traffic controller and change the technologies carried on aircraft. These technologies may lead to significant operational and procedural changes and may change the nature of the relationship between the pilot and the air traffic controller.

(b) NSL intends to significantly develop its business and activities both in the UK and abroad

2.5. About 80% of NATS' current revenue is generated by NERL. The remainder is generated by NSL. NSL's income is generated by contracts with UK and overseas airports to provide air navigation services at airports and other services such as consultancy services.

2.6. NSL is very keen to develop further its business both in the UK and abroad and deliver on NATS' publicly stated aim to generate £1 billion in sustainable revenue by 2015. NSL's revenue was £185 million in 2011/12. This compares to the total revenue for NERL of £680 million in 2011/12 of which £612 million is from price-regulated business (these figures exclude intercompany revenue of c£16 million).

Figure 2.2: NSL business development outside of the UK regulated business



Source: NATS

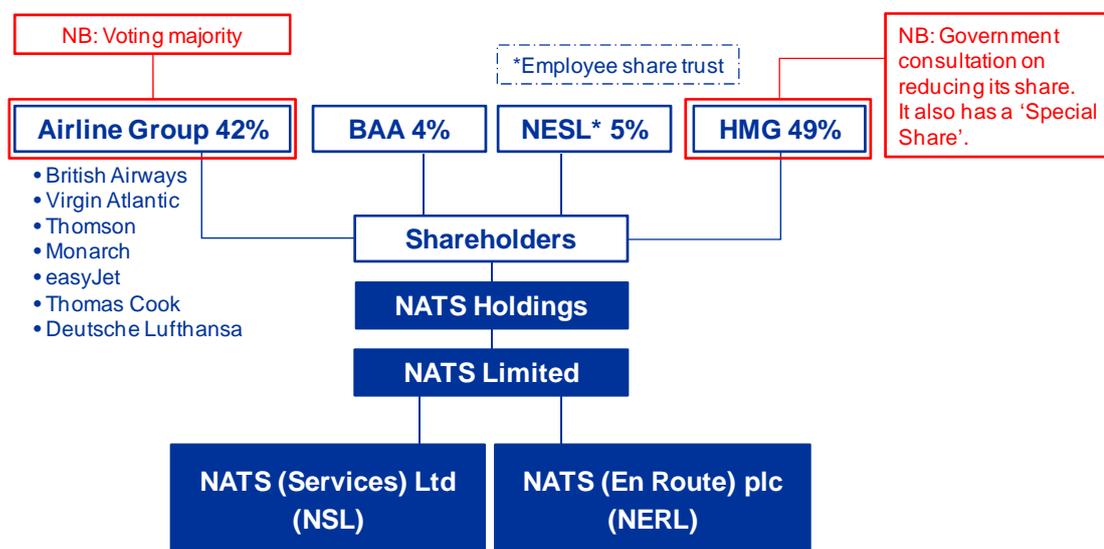
- 2.7. NATS may seek to leverage its assets, people skills and the financial strength of its NERL business to gain commercial advantage for developing its NSL business. This might include key staff resources and senior management focus. The CAA needs to be diligent to ensure that NSL does not act in an anti-competitive way or create unacceptable risks for NERL.
- 2.8. In response to increasing pressure from users, the CAA and the European Commission to reduce its unit costs, NERL has taken a more commercial approach to its regulated activities. It is increasingly likely to be expected to provide services only where it has a commercial incentive to do so and/or where it has an explicit legal or regulatory obligation.

(c) Increasing alignment of ATM regulation at the European level

- 2.9. The CAA's regulation of airspace has to be consistent with European legislation – and in particular the SES programme and regulations issued by the European Aviation Safety Agency (EASA). SES and EASA developments have increased their influence and scope in recent years and can be expected to continue to do so in the future.
- 2.10. SES has ambitious and challenging long-term goals. For example, the current SES ATM Master Plan sets out the high-level political aspiration that unit costs are reduced in real terms by 50% by 2020 when traffic is expected to be 73% higher than in 2005.
- 2.11. The European Commission expects a number of initiatives will contribute towards achieving these goals. These include:
 - the deployment phase of SESAR - a European wide coordinated research and development programme;
 - Functional Airspace Blocks (FABs) - comprising collaboration by Member States to reflect airspace synergies rather than national boundaries;
 - a Performance Scheme - which expects NPPs from Member States to contribute towards achieving EU-wide targets set by the European Commission for safety, cost-efficiency, capacity and the environment/flight efficiency; and
 - EASA - which gained sole legal competence for air navigation safety in 2009.
- 2.12. The challenge for the CAA is to ensure its regulation is consistent with its obligations under legislation. It will need to continue to work closely with DfT to identify how the UK's legislation and regulatory regime can be brought into line with European legislation and other SES and EASA developments. There also needs to be effective and efficient mechanisms for ensuring CAA's regulation of NERL and NSL implements international obligations and requirements on Member States by virtue of the UK's membership of the EU and other international organisations such as the International Civil Aviation Organisation (ICAO).

(d) The ownership structure of NATS could change

- 2.13. The ownership structure of NATS is based on a Public Private Partnership (PPP) and has been stable for some time. The Airline Group (AG) has 42% of NATS' shares but controls the majority of the voting rights.
- 2.14. Following consultation, the government announced in July 2012 that it would not be selling its shares at this time. This does not preclude a future sale. Other shareholders such as the Airline Group may also consider their options.

Figure 2.3: Ownership structure of NATS

Source: CAA

- 2.15. As the CAA cannot control the ownership of NATS and/or NERL, it will need to ensure that its regulatory framework is not dependent on one particular form of ownership. This includes gaining sufficient assurance that regulatory levers can be deployed to secure CAA's strategic outcomes regardless of any changes in NATS' or NERL's shareholding structure.

3. Draft strategic outcomes for the CAA

(a) Legal context

i. Transport Act 2000

- 3.1. The CAA's statutory duties with respect to air traffic management are set out in the Act. This Act was passed at the time that NATS was established as a PPP. It addresses both the air traffic services licensing of NERL and the broader air navigation functions of the CAA.

Figure 3.1: CAA's statutory duties with respect to economic regulation of en route air navigation services

- To maintain a high standard of safety in the provision of air traffic services.
This duty is to have priority over other duties.
- To further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them.
- To promote efficiency and economy on the part of licence holders.
- To secure that licence holders will not find it unduly difficult to finance activities authorised by their licences.
- To take account of any international obligations of the UK notified to the CAA by the Secretary of State.
- To take account of any guidance on environmental objectives given to the CAA by the Secretary of State.
- Furthering interests includes furthering them (where the CAA thinks it appropriate) by promoting competition in the provision of air traffic services.
- The CAA must impose on licence holders the minimum restrictions that are consistent with the exercise of its functions.

Source: CAA (Section 2 of the Transport Act 2000).

Notes: The Secretary of State last notified the CAA on international obligations in October 2008. The Secretary of State has not given the CAA guidance on environmental objectives with respect to economic regulation.

Figure 3.2: CAA's statutory duties with respect to its air navigation functions (airspace regulation)

- To maintain a high standard of safety in the provision of air traffic services.
This duty is to have priority over other duties.
- To secure the most efficient use of airspace consistent with the safe operation of aircraft and the expeditious flow of air traffic.
- To satisfy the requirements of operators and owners of all classes of aircraft.
- To take account of the interests of any person (other than an operator or owner of an aircraft) in relation to the use of any particular airspace or the use of airspace generally.
- To take account of guidance on environmental objectives given to the CAA by the Secretary of State.
- To facilitate the integrated operation of air traffic services provided by, or on behalf of the armed forces of the Crown and other air traffic services.
- To take account of the interests of national security.
- To take account of any international obligations of the UK notified to the CAA by the Secretary of State.
- The CAA must exercise its air navigation functions so as to impose on providers of air traffic services the minimum restrictions which are consistent with the exercise of those functions.

Source: CAA (Section 70 of the Transport Act 2000).

Notes: The Secretary of State gave guidance to the CAA on environmental objectives in 2002. This is available at: <http://assets.dft.gov.uk/publications/topics/sustainable/aviation-2/ancetothecivilaviationau2879.pdf>

3.2. As a licence holder NERL also has statutory duties under the Act.

Figure 3.3: NERL's statutory duties

- Must secure that a safe system for the provision of authorised air traffic services in respect of a licensed area is provided, developed and maintained.
- Must take all reasonable steps to secure that the system is also efficient and co-ordinated.
- Must take all reasonable steps to secure that the demand for authorised air traffic services in respect of a licensed area is met.
- Must have regard in providing, developing and maintaining the system, to the demands which are likely to be placed on it in the future.

Source: CAA (Section 8 of the Transport Act 2000)

- 3.3. Subject to any overriding EU requirements, safety is regulated by the CAA under the UK Air Navigation Order (ANO) 2009, under which elements of airspace are also regulated. Other UK airspace elements are regulated through the NERL licence (see below) and the application of Directions and Guidance made to support CAA's air navigation functions under the Act.
- 3.4. In general, UK safety requirements have been largely, though not entirely, displaced by EU requirements. There is a stronger national basis for airspace regulation, although there is a steadily increasing trend of alignment with developing EU requirements.
- 3.5. The CAA can enforce safety regulation under the ANO in a number of ways. These include:
 - criminal prosecution – as an ANO contravention is a criminal offence; and
 - licensing action – the revocation, suspension or variation of any licence, certificate or approval.
- 3.6. In common with other economic regulators, the CAA regulates NERL's performance through conditions in its licence. This covers aspects such as pricing, service quality, consultation with airspace users and its investment programme. The main changes tend to be made at the time the price control conditions are reset. The present price control period was established from January 2011 to December 2014 to coincide with the first regulatory period for the SES Performance Scheme.
- 3.7. The CAA can modify conditions in NERL's licence, subject to consultation with interested parties and agreement with NERL. If the CAA cannot reach agreement with NERL it can make a reference to the Competition Commission as the appeal body on licence modifications and new licence conditions.
- 3.8. The CAA can enforce the conditions in the NERL licence and NERL's statutory duties in the Act, through Provisional and Final Orders. Unlike some other economic licence regimes the CAA has no ability to impose financial penalties for breaches of NERL's licence conditions.

ii. Single European Sky

- 3.9. Under the SES programme, Member States and their National Supervisory Authorities (NSAs) (the CAA being the UK's nominated NSA), have a number of key responsibilities. Essentially these are to assume the supervision of providers in terms of service provision, airspace and inter-operability in accordance with the SES high-level regulations and the detailed Implementing Regulations that flow down from them e.g. on performance and charging. Key safety requirements developed under SES have already been brought within the EASA system, with more requirements to follow.
- 3.10. The Member State and its NSA have a number of mechanisms to enforce their obligations under SES. These include:

- corrective action – the NSA may require this if there is a perceived compliance failure by an Air Navigation Service Provider (ANSP). In the event that this does not produce compliance a company may be put “on notice” of potential licensing action;
 - licensing action – i.e. the revocation, suspension or variation of a certificate or designation held by an ANSP; and
 - prosecution action – as with the ANO, SES contraventions have been cast as criminal offences under UK secondary legislation, although this is expected to be used only in the most serious of circumstances.
- 3.11. With EASA having sole legal competence for safety regulation Member States cannot operate safety regimes that are inconsistent with EASA regulations. The UK is in the process of de-scoping certain aspects of the ANO where these duplicate or are inconsistent with the EASA regime.
- 3.12. Under the SES Performance Scheme, if the European Commission considers that a Member State’s National Performance Plan does not make an adequate contribution to achieving its EU-wide targets, it can direct the Member State to take corrective action.

(b) Draft strategic outcomes for the CAA’s future regulation of NERL

- 3.13. Mindful of needing to meet its statutory duties against the background of its view on the potential future trends and challenges, the CAA considers that it is important that it develops a clear view on the strategic outcomes it would like to achieve from its regulation of NERL (and NSL where appropriate). This will enable the CAA to evaluate whether it has sufficient and proportionate regulatory levers to secure these outcomes. It also gives stakeholders a sense of the priorities the CAA sees for its regulation of NERL.

Figure 3.4: Draft strategic outcomes

Assurance is required from the review that the CAA will have regulatory levers to ensure:
i. NERL continues to maintain a high level of safety and has a strategic approach that will deliver appropriate safety decisions for the future
ii. Airspace users receive significant economic value improvements through the CAA's regulation of NERL in terms of the direct costs and indirect costs of en route service provision
iii. NERL maintains sufficient financial and non-financial resources and avoids exposing en route airspace users to unacceptable risks arising from NATS' activities outside the regulated business, for example NSL
iv. NERL (and NSL) play their full part in developing the strategic capabilities necessary to deliver their contribution to FAS, including improving environmental outcomes by making more efficient use of airspace
v. There is clarity on NERL's regulatory obligations and relationships with the CAA
vi. CAA in undertaking its regulatory functions can be neutral with respect to the ownership of NERL as it has sufficient regulatory levers to achieve its objectives

Source: CAA

- i. *NERL continues to maintain a high level of safety and has a strategic approach that will deliver appropriate safety decisions for the future*
- 3.14. Consistent with the CAA's duty in the Act, and what the public expect, it must continue to gain assurance that NERL will continue to maintain a high level of safety. This must cover NERL's approach to identifying and tackling short-term operational risks as well as longer-term strategic risks.
- ii. *Airspace users receive significant economic value improvements through the CAA's regulation of NERL in terms of the direct costs and indirect costs of en route service provision*
- 3.15. In pursuing its statutory duty to further the interests of users, the CAA recognises that NERL can generate or reduce economic value in a number of ways. Traditionally, the CAA's economic regulation has focused on two areas: the level of en route charges and the performance of NERL with respect to en route airspace related delays. The CAA supports the European Commission's aspirations for a greater contribution from the UK, including NERL, towards the achievement of the EU-wide cost-efficiency target during RP2 of the EU Performance Scheme.
- 3.16. In addition to focusing on achievement of RP2 targets under the Performance Scheme covering, amongst other things, direct charges for airspace users and NERL's cost-efficiency, the CAA is also interested in incentivising NERL to enhance the broader economic value it provides users. For example, the CAA has recently

incentivised NERL in relation to efficient flight trajectories that are aimed at saving airlines fuel costs and reducing carbon emissions.

3.17. The CAA's economic regulation takes place within the context of the SES Performance Scheme. The UK is fully committed to ensuring it meets its obligations under the Performance Scheme including a sufficient contribution to achieving European-wide targets in RP2.

iii. NERL maintains sufficient financial and non-financial resources and avoids exposing en route airspace users to unacceptable risks arising from NATS' activities outside the regulated business, for example NSL

3.18. Financial and resourcing resilience is a critical foundation for a licence holder such as NERL being able to provide a safe, efficient and sustainable service. While there are potential synergies that might benefit regulated businesses, there are also potential risks of regulated businesses being dependent upon, or exposed to, risks arising from unregulated businesses within the same group structure, especially if financial distress of the unregulated business has an ability to cause financial distress of the regulated business.

a. NERL (and NSL) play their full part in developing the strategic capabilities necessary to deliver their contribution to FAS, including improving environmental outcomes by making more efficient use of airspace

3.19. The CAA developed FAS with industry stakeholders to set a clear long-term vision on how airspace management and policy should develop to meet the challenges of the future.

3.20. The FAS will form the national contribution to SESAR. Whilst FAS is a national strategy it was drawn up fully in the context of emerging European and other international requirements and was entirely consistent with what were known to be the emerging themes. It is important that FAS is compliant with other EU airspace initiatives and does not drive the UK in a direction that is in conflict with greater integration across Europe in its widest sense rather than just with the other EU Member States.

3.21. NERL is a critical player in the delivery and realisation of FAS and the UK contribution to SESAR. Therefore, it is essential its incentives are aligned to delivering its full contribution to FAS in a timely, effective and value for money way. This also applies to NSL to the extent that FAS requires airport related air navigation changes.

iv. There is clarity on NERL's regulatory obligations and relationships with the CAA

3.22. As NERL and NSL intensify their commercial focus there is a need in some areas for the CAA to be clear about the boundaries for their conduct. This reduces regulatory uncertainty and risk and will provide a higher degree of assurance that desired regulatory outcomes can be secured.

- v. *CAA in undertaking its regulatory functions can be neutral with respect to the ownership of NERL as it has sufficient regulatory levers to achieve its objectives*

3.23. A stable and effective regulatory regime is one that is neutral with respect to the ownership of NERL (and NATS). The CAA has no controls over ownership and therefore it needs to seek assurance it has appropriate and adequate regulatory levers to secure its desired outcomes regardless of the ownership at any point in time¹.

(c) Ensuring the CAA's regulation remains proportionate and targeted over time

3.24. The CAA takes a risk-based approach to the regulation of NERL and wishes to ensure that its regulatory framework remains consistent with the government's Better Regulation Principles over time.

3.25. This particular ad hoc review has not looked at all the possible interactions the CAA has with NERL and NSL. It would also be disproportionate and untargeted for the CAA to attempt to consider all possible future scenarios and seek to regulate for them. Instead, the CAA has evaluated whether it has flexible enough regulatory levers to respond in a range of circumstances related to its ability to secure the draft strategic outcomes above.

3.26. The CAA considers that its approach should continue to be risk-based and subject to periodic review to ensure that it remains appropriate as new information comes to light.

(d) Draft recommendation

3.27. **Recommendation 1:** The future is inherently uncertain so there is merit in the CAA continuing to adopt a risk-based approach to its regulation of NERL. There is also merit in it periodically reviewing its regulatory framework to ensure that it remains consistent with Better Regulation Principles.

¹ The Secretary of State can revoke NERL's licence if a change of ownership would be against the interests of national security or the UK's international relations.

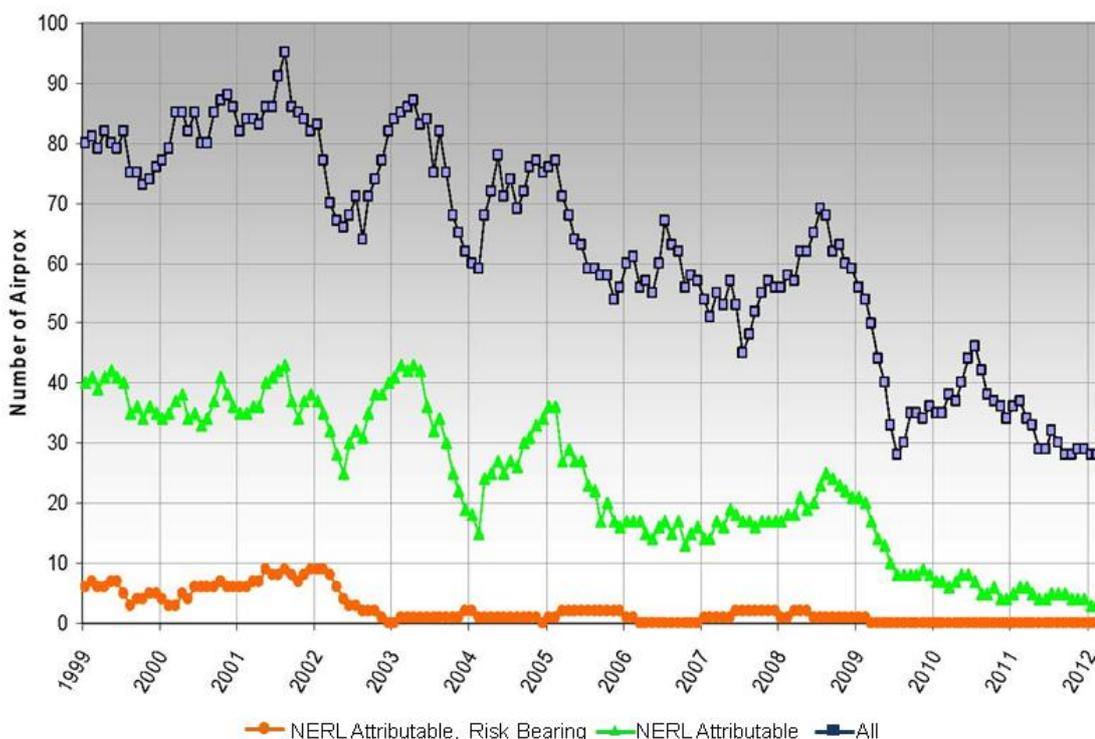
4. Enhancing safety outcomes

Draft strategic outcome:

NERL continues to maintain a high level of safety and has a strategic approach that will deliver appropriate safety decisions for the future

- 4.1. The CAA has a high level of assurance about NERL's safety competence and its Safety Management System (SMS). This section looks to the future and considers the challenges that face NERL in maintaining its high standard.

Figure 4.1: NERL safety performance



Source: CAA

(a) Potential future risks to achieving the CAA's strategic outcome

i. Strategic safety risks arising from long-term traffic and technology trends

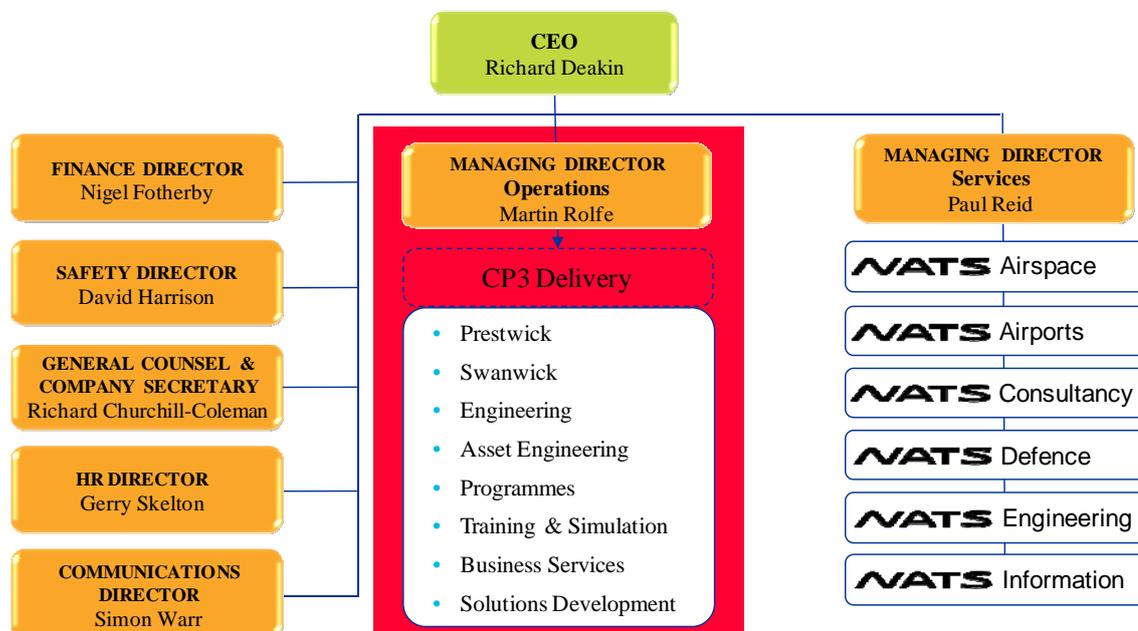
- 4.2. The challenge for both NERL and the CAA is that the future risk environment requires both organisations to think longer-term and more strategically about the nature of safety risks in addition to ensuring that tactical day-to-day safety is maintained.
- 4.3. NERL's safety plans currently have a five-year forward view. However, there are a number of trends that will necessitate NERL extending this with a longer-term

perspective to address the potential risks from long-term traffic growth, congestion and technology changes.

- 4.4. Emerging technological innovations, in particular through SESAR and further articulated in the FAS, will generate significant operational and procedural changes. There will be challenges for both providers and regulators as they grapple with new technologies that may be required to address a more integrated systems approach to safety. For example, this is likely to change the relationship between air traffic controllers and pilots, and the ground-based and airborne equipment, as part of a whole systems approach. Ensuring that these change management and transition risks are adequately identified and tackled is a key challenge for NERL and the CAA.
- 4.5. Work being completed under the FAS is designed to ameliorate some of these risks, especially through programmes such as the London Airspace Management Programme (LAMP). These initiatives are as important to long-term safety performance as they are to airspace efficiency and economic performance.
- 4.6. It is important that NERL's resourcing, systems and management commitments adequately take into account likely long-term safety risks and outcomes. Risks could arise if NERL does not adequately prioritise and resource the identification and mitigation of longer-term safety risks. There may also be risks if NERL does not have appropriate incentives to deliver its contribution to FAS programmes in a timely, effective and value for money way.
- 4.7. The CAA's regulation will need to keep pace with technological innovations. At present there is limited NSA involvement in SESAR, apart from a small group of NSAs (including the CAA) working on discrete tasks and validation work with the SESAR Joint Undertaking. The potential risk of regulatory misalignment may need to be addressed.
- 4.8. With NERL increasing its collaboration with international partners and equipment suppliers it is important that there is a clear, effective and efficient regulatory framework. Risks could arise if this greater collaboration by NERL with other parties were to lead to regulation that was either aimed at the lowest common denominator or prohibited efficient changes to regulations to keep pace with technology developments.
 - ii. *Maintaining adequate resources and management focus with a more diversified business*
- 4.9. NATS is keen to use synergies between NERL and NSL and to help develop its non-economically regulated businesses. NATS has recently reorganised internally to develop a distinction between Operations (which is responsible for compliance with the NERL licence) and Services, which is focused on winning and servicing an increasing number of contracts both in the UK and in other countries. Risks could

arise if NERL dilutes its focus and resources developing its longer-term safety in pursuit of NSL's commercial aspirations.

Figure 4.2: NATS operational structure



Source: NATS

(b) The CAA's available levers to address the potential future risks

i. Strategic safety risks arising from long-term traffic and technology trends

- 4.10. Regulatory levers can range from 'hard' levers such as enforcement and prosecution to 'soft' levers such as working in collaboration to reach a defined and shared objective. Improving strategic or long-term safety capabilities may lend itself more to the 'soft' levers rather than 'hard' levers, such as collaboration with NERL and the provision by the CAA of a greater level of proactive oversight of its approaches to managing longer-term safety risks.
- 4.11. The main regulatory lever for ensuring that NERL has sufficient focus on long-term strategic safety risks is the CAA's oversight of the NERL Business Plan that is required as part of the SES (now EASA) Common Requirements Regulation. Under the Common Requirements (Commission Regulation 1035/2011), ANSPs, such as NERL, must maintain adequate technical and operational capacity and expertise to provide their service in a safe, efficient, continuous and sustainable manner. This includes a requirement to ensure appropriately skilled staff are employed.
- 4.12. NERL is required under its licence to produce, and consult on, a ten year plan ahead of every price control period which sets out investment and operational plans for the next ten years and describes measures that will be taken to improve the efficiency and effectiveness of the operation over that time period. It includes traffic

and service quality forecasts, capital and operating expenditure projections, safety plans, regulatory income statements, cash flow projections and projections regarding the value of the Regulatory Asset Base (RAB) over the next ten years. It also has to report each year on its performance against the plan.

- 4.13. As part of the Common Requirements NERL (and NSL) must produce for the CAA a Business Plan for a minimum of a five year period, which sets out, among other things, NERL's overall aims and goals and its strategy towards achieving them. This Business Plan should embrace how NERL takes a strategic approach to safety.
- 4.14. Annually, NERL (and NSL) must also submit a Business Plan Report to the CAA. This is more backward looking than the Business Plan and must set out any changes to the Business Plan over the year and NERL's annual progress in the key SES performance areas such as safety, cost-efficiency, environment, and capacity. It should also cover NERL's infrastructure developments, short-term financial position, and human resource policy.
- 4.15. The CAA has powers under the Common Requirements and the related EASA Safety Oversight Regulation to scrutinise these NERL plans and require changes. This is related to a general process for NSA verification of ANSP compliance against the Common Requirements. If compliance cannot be demonstrated the NSA can require corrective action.
- 4.16. The CAA has to date dedicated its resources to only a limited oversight of these NERL plans. The CAA's focus has instead been on NERL's SMS and day-to-day operational safety performance. There is merit in the CAA dedicating and prioritising more resources to provide proactive robust challenge and oversight to NERL on the Common Requirements Business Plan with a view to gaining regulatory assurance that NERL has sufficiently thought through and resourced its approach to tackling longer-term safety risks. This more proactive stance aligns with the CAA's thinking on its Enhancing Safety Performance (ESP) programme and the approach that it is considering for NERL-related financial risks (see section 6).
- 4.17. The CAA's enforcement powers include the ability to withdraw NERL's certification and criminal prosecution. The CAA has powers to enforce NERL's statutory duties under the Act through Provisional and Final Orders, but it has no powers to impose financial penalties.
- 4.18. There is a question as to whether such enforcement levers are credible in relation to the nature of strategic safety risks. In particular, they may lack gradualism and could be considered disproportionate to tackle a risk that by its nature is long-term and subjective rather than present and objective.
- 4.19. To address the lack of gradualism in the CAA's enforcement powers, and mindful of the Macrory recommendations on the use of civil sanctions, there is merit in initiating further discussion with DfT on civil sanctions. Breaches of national safety legislation are cast as criminal offences (apart from powers to revoke, vary or

suspend licences or certificates), and currently the UK penalties required for breaches of EU safety legislation are cast in the same mould. While this was done in part for reasons of consistency with the existing UK criminal offences regime, it may be that a fresh look is needed at the range of possible safety breaches, and whether a more targeted and proportionate approach is possible for some or all of them through civil sanctions, or indeed a regulatory tool-kit in which civil sanctions sit alongside criminal sanctions. There may also be merit in the CAA seeking to discuss with DfT its position on the use of civil sanctions (i.e. financial penalties) in relation to enforcement of the NERL licence alongside Provisional or Final Orders in the Transport Act (see paragraph 8.11). These types of sanctions are available to most other economic regulators.

- 4.20. The CAA has considered the merits of introducing into the NERL licence conditions that might support its ability to ensure an adequate focus on longer-term safety risks. On balance, it does not consider this an appropriate step because:
- the Act would need to be amended and updated to enable this;
 - the processes foreseen in the Act are cumbersome and hedged with preconditions; and
 - a contravention could remain difficult to prove given the lack of a specified baseline for compliance.
- 4.21. To facilitate more proactive oversight by the CAA there may be merit in seeking to consolidate and align, where it is feasible to do so, the various business planning requirements to which NERL is subject under EU requirements and its licence.
- 4.22. There are a number of process steps the CAA can take to help regulation keep pace with technological developments and the various collaborations NERL has with third parties. These include:
- working with relevant parties such as the European Commission, Eurocontrol, EASA and other NSAs to define an appropriate forum for considering the regulatory implications of SESAR;
 - continuing to work with NERL to ensure that its SMS develops to meet these challenges;
 - continuing to work with EASA to ensure that the regulatory framework develops to meet the challenges of a total systems approach; and
 - working with other Competent Authorities to ensure effective and efficient safety oversight processes for any systems developed through NERL's collaboration with third parties, including any FAB involving NERL.

ii. Maintaining adequate resources and management focus with a more diversified business

- 4.23. The CAA's scrutiny of the NERL Business Plan under the EASA Common Requirements should help ensure that NERL dedicates sufficient resources to tackling longer-term and strategic safety risks. However, if resources, including suitably qualified staff, are diverted from NERL to winning and servicing contracts for NSL in a manner that has a detrimental effect on NERL's focus on safety, the CAA has the ability under the NERL licence to enforce its licence obligation (Condition 5(2)) that requires:

'The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, to enable it to comply with its obligations under the Act and this licence.'

- 4.24. This requirement clearly goes beyond financial resources and covers NERL's obligations under the Act and licence, the former of which includes NERL's safety duty. Monitoring NERL's compliance with this obligation is discharged under licence Condition 5(3) by NERL submitting to the CAA an annual certificate giving its Directors' view on the availability of resources over the following 24 months.
- 4.25. Consistent with a risk-based approach to regulation, the CAA has previously dedicated limited resources to its oversight of this certificate. In keeping with the CAA's re-assessment of the risk environment and the merit it sees in gaining more proactive assurance of NERL's Business Plans under the Common Requirements, there is merit in the CAA subjecting NERL to closer scrutiny and challenge over the assumptions it has made to prepare its annual certificate.
- 4.26. The importance of NERL's certificate is that it goes beyond financial resources and includes without limitation other resource such as qualified staff, management systems, assets, etc, which may be more directly relevant to providing the CAA with assurance on NERL's approach to long-term safety risks.
- 4.27. To supplement closer regulatory scrutiny of NERL's availability of resources certificate, the CAA is considering the merits of introducing a licence condition that requires NERL to assess and report to the CAA on the risks that NERL is exposed to by virtue of its relationships and interactions with the wider NATS group of companies and the mitigations that NERL has put in place (see section 6 for a fuller discussion).

Effective NERL governance is also required to ensure that the regulated business maintains sufficient technical focus and does not impair its capabilities by putting NSL and other NATS business interests ahead of NERL's objectives (see section 7 for a fuller discussion).

(c) Draft recommendations

- 4.28. **Recommendation 2:** The CAA should ensure that NERL continues to enhance its strategic safety risk capability. This includes the mitigation of total systems risks and tackling longer-term risks arising from traffic, congestion and technology trends. NERL needs to articulate its approach through Business Plans required under the EASA Common Requirements. There may be merit in the CAA subjecting these plans to increased regulatory oversight and scrutiny. There may also be merit in the CAA subjecting to increased oversight and scrutiny NERL's annual certificate on its availability of resources as this goes beyond financial resources and includes systems, staffing, management resources, etc.
- 4.29. **Recommendation 3:** NERL is increasingly collaborating with international partners and NSL is seeking more commercial contracts in the UK and abroad. The CAA should continue to work with other Competent Authorities to ensure that NERL's technical collaborative arrangements with other ANSPs and equipment suppliers contribute to improving UK safety and do not have negative effects on NERL.

5. Economic value to airspace users

Draft strategic outcome:

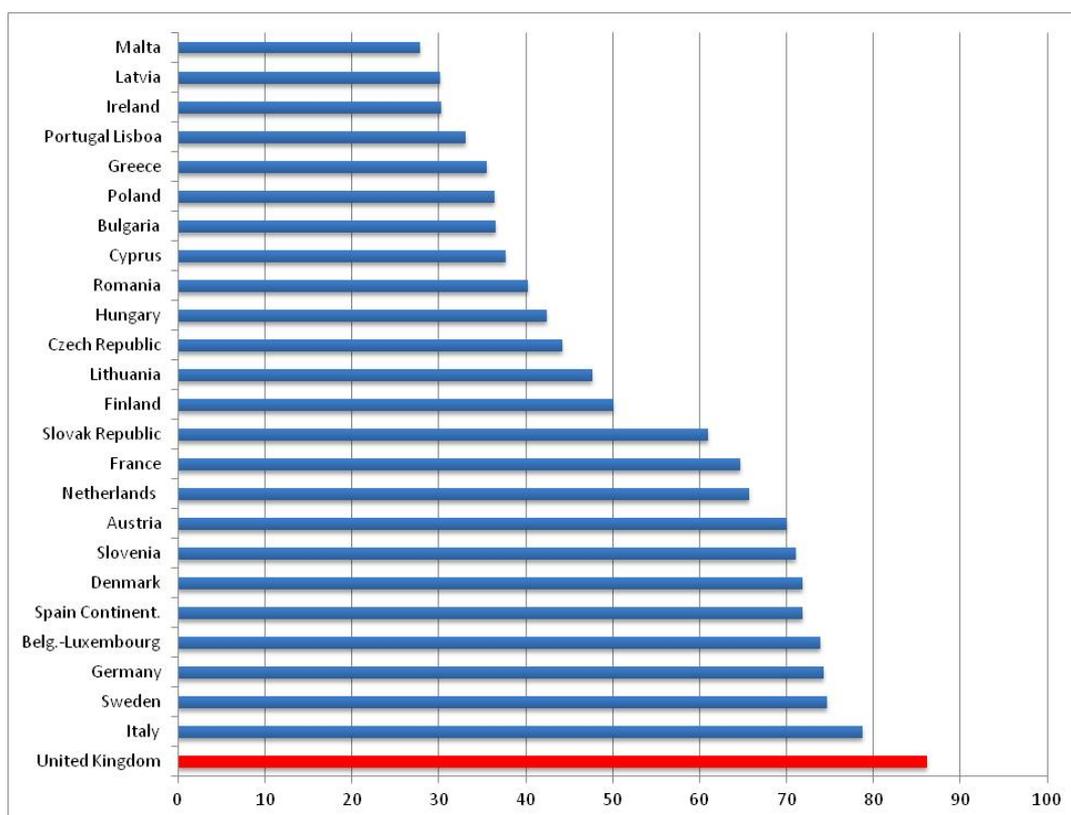
Airspace users receive significant economic value improvements through the CAA's regulation of NERL in terms of the direct costs and indirect costs of en route service provision

(a) Potential future risks to achieving the CAA's strategic outcome

i. NERL efficiency incentives and ability to reduce en route charges

- 5.1. Users expect the CAA to regulate the prices that NERL can charge for its monopoly services. In doing so the CAA must discharge its statutory duties. Whilst furthering the interests of users and promoting efficiency may lend itself to setting lower charges than would otherwise be the case, the CAA has to be mindful to ensure NERL is able to provide continuity of service and that it does not find it difficult to finance its licensed activities or compromise the maintenance of a high level of safety.
- 5.2. The CAA's economic regulation of NERL's charges must be consistent ultimately with the UK's obligations under SES and particularly the Performance Scheme. For example, Member State cost-efficiency performance, measured by the Determined Unit Rate (DUR), has to make a sufficient contribution towards EU-wide targets that are set by the European Commission.
- 5.3. NERL's en route charges account for about 85% of the UK's DUR². This is the highest in the EU despite planned reductions in real terms over RP1 (2012-2014).

² The remainder of the UK DUR comprises contributions relating to certain CAA and DfT costs (e.g. Met Office).

Figure 5.1: EU Unit Rates, July 2012 (€)

The UK's Unit Rate is set in sterling, although in Figure 5.1 it is converted to Euros for comparison to other States.
Source: Eurocontrol

- 5.4. The European Commission's Performance Review Body (PRB) challenged the UK for a more significant contribution in reducing ATM charges across Europe in RP1. The CAA reviewed the extensive analysis it undertook for setting the last NERL price control and was satisfied that the NERL element of the DUR was appropriate for RP1. The European Commission has not required the UK to take further action to reduce charges in RP1 but has set clear expectations for a greater contribution from the NERL component of the UK DUR in RP2.
- 5.5. As part of its preparations for RP2 the CAA will undertake the next price control review of NERL in line with the EU process (this was not fully possible last time owing to the CAA's review and the EU timetable not being aligned). The European Commission's draft EU-wide cost-efficiency targets³ will not be known until June 2013 and they will not be finalised until the end of 2013. The CAA will need to reconcile the bottom up approach that it has applied in previous price reviews (which involves the detailed assessment of building blocks including regulatory asset base, cost of capital, and operating costs) with the top down aspiration for greater unit cost efficiency. For example, the scale of NERL's cost-efficiency will be influenced by traffic projections, owing to the 'per unit' nature of the EU benchmark and the large share of fixed costs required by the business. It may also be

³ Cost efficiency targets are expressed as reduction in the unit rate (i.e. prices).

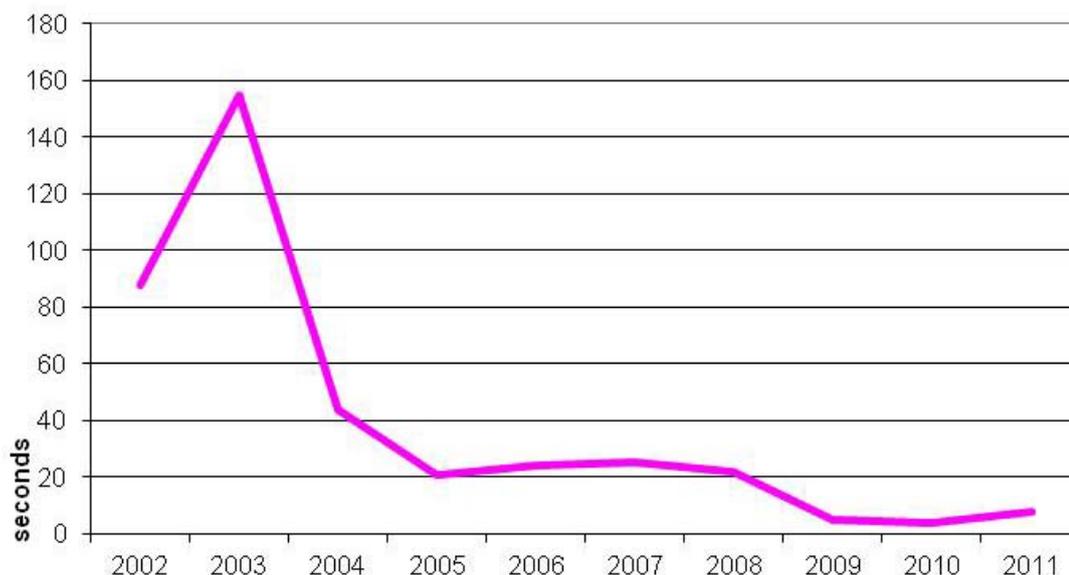
influenced by whether the defined benefit pension scheme has a surplus or deficit and its scale.

- 5.6. Despite these uncertainties and challenges NERL will need to prepare thoroughly in order to respond positively to stakeholders' expectations that it make a more significant contribution to increased levels of cost-efficiency performance for RP2.
- 5.7. The main risk arises if NERL fails to sufficiently prepare to be able to meet these expectations. A risk may also arise if the EU-wide cost efficiency target is set at such a high level that it would undermine NERL's ability to finance its licensed activities or provide the requisite level of service its users demand.

ii. Airspace users are expecting NERL to deliver significant value in a number of ways aside from reducing the level of en route charges

- 5.8. ATM delays have a significant cost for users in terms of fuel and crew costs. They also have a significant impact on end users in terms of travel time delays.
- 5.9. NERL has delivered significant value to airspace users through its delay performance. This has been incentivised by the CAA setting financial incentives within the NERL price control. Users might expect these gains to be 'locked in' and hence they would be concerned about any risk that would lead to a deterioration in NERL's performance.

Figure 5.2: NERL's annual delay performance – average delay per flight

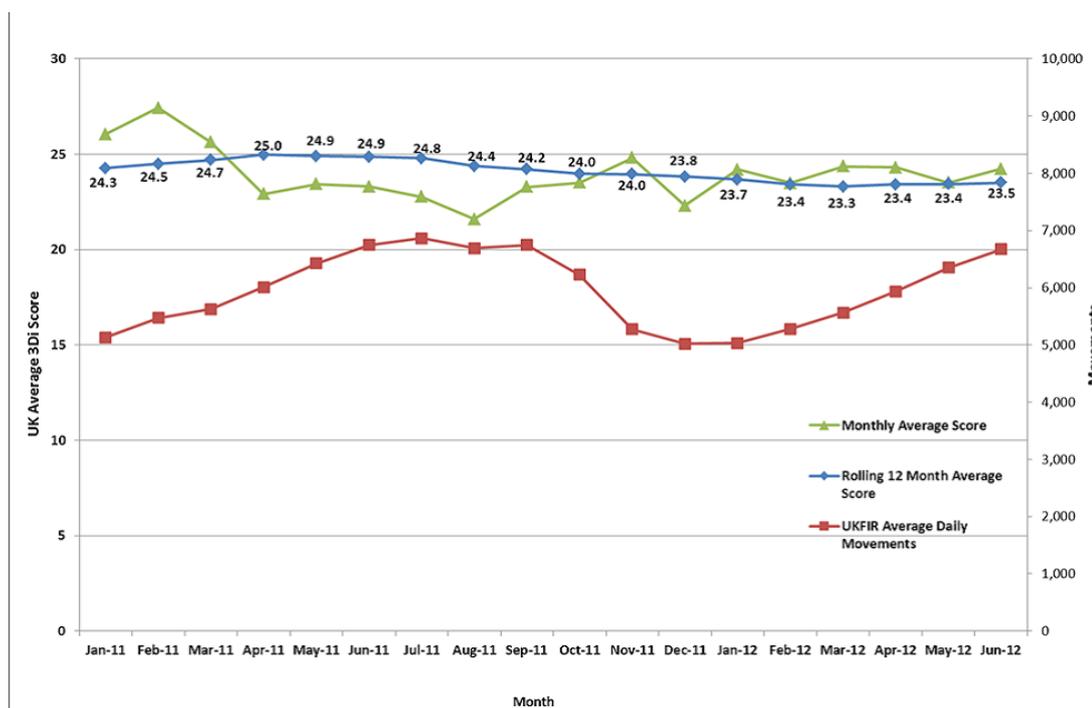


Note: In the six months to June 2012, average delay was around 2 seconds.
Source: CAA

- 5.10. Flight path efficiency is also important to airspace users as it directly affects their costs in terms of fuel consumption and their carbon emissions. NERL and CAA

have delivered value improvements to users in terms of flight efficiency by developing an incentivised environmental metric. This metric captures both the vertical and horizontal elements of flight trajectories. The performance parameters for this metric have been incentivised by the CAA by regulatory targets included within the NERL price control. En route airspace users expect NERL to further improve its performance - especially in relation to stack holding around Heathrow airport - and users would be concerned with any risks that could lead to deterioration in NERL's performance.

Figure 5.3: NERL's flight efficiency performance



Source: NERL

5.11. The UK is required to submit its NPP for RP2 to the European Commission by May 2014. The European Commission is likely to expect FAB plans rather than State plans and hence the CAA is discussing with the IAA how to develop an approach that delivers benefits to users at the FAB level.

(b) The CAA's available levers to address the potential future risks

i. NERL efficiency incentives and ability to reduce en route charges

5.12. The main regulatory lever available to the CAA is its next review of the NERL price control. This ultimately leads to modifications of the NERL licence to implement its conclusions. These need to be agreed with NERL or else the CAA needs to refer the matter to the Competition Commission.

- 5.13. The CAA shares the European Commission's aspiration for a more significant contribution from NERL towards cost-efficiency. In assessing the appropriate level of the price caps the CAA's duties indicate a need to assess whether there are any adverse consequences for safety and the ability of NERL to finance its licensed activities. The CAA's financing duty in the Act is not replicated at the European level. For a privately financed business such as NERL, it would not be in users' interests if the business could not finance its business on competitive terms. The CAA also needs to take into account users' requirements for capacity and continuity of service when setting the level of the charges.
- 5.14. There are a number of issues raised by the PRB's assessment of the UK's NPP for RP1 that will help shape the priorities for the CAA's scrutiny of NERL's business plan for RP2. The CAA will also have regard to any studies carried out by the European Commission, such as the one proposed on the return on equity among European ANSPs.

Figure 5.4: PRB views on the UK's cost-efficiency performance

Conclusions on capacity

The Addendum to the United Kingdom Performance Plan contains revised targets which, if met, will provide an adequate contribution to the EU-wide capacity target.

Conclusions on cost-efficiency

A. UK has not revised its targets for cost-efficiency for RP1 from the information submitted in the initial Performance Plan in June 2011. The en route DUR trend over 2009-2014 remains -0.9% p.a.

B. Against this backdrop, the PRB notes that the capacity target has been revised and is more challenging than that adopted in the initial June 2011 Performance Plan.

C. The PRB takes good note that the UK has looked at targets in the context of the total economic value for airspace users, including in particular flight efficiency / environment. The UK considers that the specific incentive on flight efficiency set on NERL could generate around £120m in fuel cost savings to airlines over RP1, in addition to significant environmental savings through reduced emissions. The PRB welcomes this initiative as, in principle, it should drive behaviour and improved ANS performance.

D. However, the PRB also reckons that the monetary value of the estimated benefits (£120m) is subject to complex modeling assumptions. The PRB also notes that with the defined par values and dead band around the par value (± 3 units), the scheme would also potentially allow for £120m of disbenefits without NERL having to incur an explicit financial penalty. Therefore, the PRB considers that delivery of the operational benefits will be key and will have to be effectively monitored during RP1.

E. Given that the en route DURs provided in the UK Performance Plan for RP1 were not revised, UK does not contribute towards reducing the EU-wide cost-efficiency gap over RP1 identified in September 2011. This outcome will be carefully considered by the PRB in the context of the RP2.

Source: PRB

- 5.15. In undertaking its assessment the PRB highlighted several areas where it has questions about the UK's approach and especially NERL's cost-efficiency. These involved the appropriate level for the return on equity (risk premia), the levels of depreciation, and the approach to traffic forecasting and accounting for inflation.
- 5.16. The CAA's bottom-up review of the appropriate levels for NERL price caps will enable it to contribute an evidence-based view to the PRB on what is an adequate and consistent contribution from the UK towards the EU-wide targets.
- 5.17. In order for the CAA to ensure that its price control for NERL in RP2 makes a sufficient contribution to the achievement of the European Commission's EU-wide targets, including on cost-efficiency, NERL must begin to prepare to meet challenging targets and to be able to respond positively to these targets once they are known.
- 5.18. As a first step the CAA considers that NERL should begin to prepare a business plan for the next price control review that is based on CAA scenarios for expectations of the EU-wide targets on cost-efficiency. Any deviation from the EU-wide targets will need detailed and sound evidence-based justifications that are capable of convincing the CAA, the PRB, the European Commission as well as users. The CAA set out scenarios in its consultation on preparing for the NERL price control component of RP2 in July 2012⁴.
- ii. *Users are expecting NERL to deliver significant value in a number of ways aside from the level of charges*
- 5.19. As part of the NERL price control review the CAA will need to review the appropriate incentives on other aspects of NERL's performance to ensure that users gain improvements in economic value. This includes, but is not limited to, incentives in relation to delay and flight efficiency.
- 5.20. There may be merit in the CAA, working alongside the Irish Aviation Authority (IAA), its FAB partner, developing a better understanding of the interactions and potential trade-offs between various aspects of economic performance. For example, how can NERL reconcile reducing unit costs with ensuring there is no adverse implications for service provision such as delay performance? And would significant cost reductions have an impact on NERL's ability to invest in the strategic capabilities required for FAS and SESAR and managing longer-term safety risks?
- 5.21. An approach assessing total economic value has been floated by the PRB in its recent consultation document on RP2. Total economic value has not been defined precisely at this stage and may not be formally part of the Performance Scheme for RP2. However, it could be a useful way to assess inter-dependencies between key performance areas and take into account both the direct costs for users through en

⁴ A consultation on the CAA's process for developing economic regulation for Reference Period Two under the Single European Sky. <http://www.caa.co.uk/docs/2460/RP2Process.pdf>

route charges and indirect costs for users that arise through other aspects of the ANSP's performance.

5.22. Although the development of total economic value may provide an insight into inter-dependencies and trade-offs between the key performance areas such as cost and capacity, the CAA does not see it as a mechanism for NERL to circumvent its obligations to make a sufficient contribution to the EU-wide cost-efficiency target. To help promote thinking in this area the CAA facilitated an EU-wide stakeholder symposium on Total Economic Value on 16 July 2012 at the London School of Economics, chaired by Professor Martin Cave⁵. Among the conclusions were that:

- The concept is better termed total economic cost given it focuses on both the direct costs of service provision (charges) as well as the indirect costs of delay and flight inefficiency;
- it should be viewed as a complement to, not a substitute for, a continued focus on improving unit cost efficiency; and
- it is important the concept gains wide stakeholder buy-in, especially from users given it is principally aimed at lowering their total costs arising from ANS.

(c) Draft recommendations

5.23. **Recommendation 4:** The CAA should ensure that its price control for NERL in RP2 makes sufficient contribution to the achievement of the European Commission's EU-wide targets, including on cost-efficiency. NERL must prepare to respond positively to the European Commission targets and the level of contribution that will be expected. As a first step NERL should prepare a business plan that is based on CAA scenarios for expectations of the EU-wide cost-efficiency targets. Any deviations should be evidenced and soundly justified by NERL to persuade users, the CAA, the PRB and the European Commission.

5.24. **Recommendation 5:** With users expecting NERL to contribute to improving total economic cost - whilst ensuring that it remains focused on raising its game on cost efficiency - there may be merit in the CAA working with industry, its FAB partners, and the PRB, to explore and promote more intelligent ways of measuring the inter-dependencies between various key performance areas.

⁵ The agenda and presentations from this symposium can be found here: www.caa.co.uk/npp

6. Sufficient resources for regulated activities

Draft strategic outcome:

NERL maintains sufficient financial and non-financial resources and avoids exposing en route airspace users to unacceptable risks arising from NATS' activities outside the regulated business, for example NATS (Services) Limited

(a) Potential future risks to achieving the CAA's strategic outcome

i. NERL's access to sufficient financial and non-financial resources

6.1. The main risk arises if NERL does not have access to financial resources (including sufficient liquidity) or it does not have sufficient access to other resources, for example, staff, technical expertise, assets and senior leadership focus on NERL issues. There is also a question as to how NERL can demonstrate it has adequate resources when it is required to contract for its staff resource with a NATS business that is not regulated and outside the NERL licence ring-fence.

ii. NERL financial exposure to risks arising from other NATS group activities

6.2. The NERL licence contains various ring-fencing conditions that in principle are aimed at protecting the regulated business from risks arising in the wider NATS group. Therefore, if financial or operating difficulties arise in, say, NSL, the regulated business is resilient. These conditions are similar to those adopted in some other economic regulated sectors, such as water and energy.

6.3. Since the NERL licence was granted the CAA has derogated the application of these ring-fencing provisions by providing NERL with various 'consents'. These consents are envisaged by the licence and, upon application from NERL, the CAA must not unreasonably delay granting its consent. The nature of these consents concerns the ability of NERL to pledge security and its ability to take on cross-default obligations in relation to third parties including businesses in the wider NATS group.

Figure 6.1: Overview of CAA's ring-fencing consents

<p>The licence has a financial ring-fence similar to other regulatory regimes.</p>
<p>But since its inception the licence has given the CAA an explicit function to consent to exemptions/derogations from the ring-fence provisions.</p> <ul style="list-style-type: none"> • The licence requires that CAA consent may not be “unreasonably delayed”. • Consents are time limited but have longevity – they have been granted to expire on the expiry of the financing to which they relate (currently: bank debt: 2017, bonds: amortised 2011 to 2026).
<p>The CAA has a duty under the Act not to make it unduly difficult for NERL to finance its licensed activities.</p>
<p>NERL has never had a full ring-fence. The CAA since PPP has on seven occasions granted/reaffirmed certain ‘consents’ that effectively weaken the ring-fence by enabling NERL to:</p> <ul style="list-style-type: none"> • grant security over its assets for activities outside the permitted activities; • enter into cross-default type obligations (i.e. a default within the NATS group such as NATS Limited or NSL creates an event of default for NERL).

Source: CAA

- 6.4. The requirement for cross-default consents goes to the heart of the NATS staffing structure. The structure, which is unchanged since PPP (and granting of the first licence), means NERL does not have staff of its own and contracts for staff resources from NATS Limited, which is not a regulated business and is outside the licence ring-fence. Creditors perceive that if NATS Limited is financially distressed this could have knock-on effects for NERL's financial resilience. NATS Limited could be exposed to risk either from its own activities or from its other subsidiary NSL. NERL's licence requires, and the CAA has obtained, undertakings from the various ultimate holding companies of NERL that they (and their subsidiaries) will take no action that would cause NERL to be in breach of its licence or statutory obligations.
- 6.5. The CAA has faced difficult choices in the past when considering granting these consents. If it did not grant consents, NERL may not have been able to raise the finance it needs on reasonable terms, thus challenging the CAA's statutory duty not to make NERL's financing “unduly difficult”. On the other hand, by granting such consents, the CAA is acknowledging a ‘risk bridge’ for example, from NSL's activities to NERL's financial resilience. The environment for these risk bridges depends on the nature, scale and risk profile of NSL's business activities.
- 6.6. The nature of the security consent is different and relates to the desire of creditors to minimise any regulatory uncertainty with regard to their security enforcement rights.

iii. NERL governance

- 6.7. Effective governance is critical to any business meeting its objectives and managing risk. NATS applies the UK Corporate Governance Code and its Annual Report and Accounts explain its departures from the Code's description of best practice. This mainly relates to the appointment of directors, which is governed by the provisions in the NATS shareholders' Strategic Partnership Agreement (SPA). NERL does not apply the Code, nor is it required to do so given it is part of a wider group structure that does apply the Code.
- 6.8. NATS is similar to many group structure companies whereby its directors sit on the Boards of a number of the group's companies. However, it is important that NERL directors when they sit as the NERL Board do not put the objectives of other NATS group businesses above those of NERL.

Figure 6.2: Overview of NERL's governance

NATS Holdings Ltd is required by the shareholder agreements to meet the requirements of the UK Corporate Governance Code. NERL is not under that obligation in its own right.

Some elements of the UK Code on Corporate Governance are not consistent with the partnership nature of the NATS Group ownership. The principal areas where NATS does not comply are:

- A.2.2, C.3.1: The Chairman is nominated by AG, and approved by the SoS Transport. He therefore does not fully meet the independence criteria as set out in the Code. He is, however, regarded in practice as the independent member of the Board in terms of the Code criteria.
- A.3, C.3.1: The NEDs on the Board are either AG nominee directors, BAA nominee directors, or Crown appointments (Partnership Directors) with particular responsibilities set out in the SPA, and therefore do not meet the independence criteria as set out in the Code.
- A.4.1-4.3: The manner in which directors are appointed, as noted above, means that processes of the Nomination Committee do not fully comply with the Code.
- A.4.4: The AG nominee directors and Partnership Directors do not have service contracts with NATS and, as a result, the terms and conditions of appointment cannot be made available for inspection. The Partnership Directors are engaged on three-year fixed-term contracts and have letters of appointment from the DfT. The Chairman has a service contract with NATS. The BAA nominee director has a service contract with NATS which can be terminated by BAA or through resignation.
- A.7.1-2: The NEDs are appointed by the shareholding groups and are therefore subject to the relevant shareholding group's selection processes, rather than those included in the Code. They are therefore not subject to periodic re-election or to specific appraisal processes after exceeding six years' service.
- B.1.3 and B.2.3: The level of remuneration for NEDs was initially determined on completion of the PPP transaction.
- Parts D and E: Within the PPP structure, there are no institutional or public shareholders. However, the nature of the Strategic Partnership is such that the shareholders have representatives amongst the directors, with whom they enjoy a close working relationship. All NEDs are invited to relay the views of their respective shareholders into Board discussions. In addition, the Chairman is in regular contact with the shareholders. The Board is therefore able to take decisions in the best interests of the company, having taken account of the views of the shareholders.

NERL Directors: John Devaney (non-exec), Richard Deakin, Nigel Fotherby, Martin Rolfe. All are also Directors of NATS Holdings Ltd (Devaney, Deakin, Fotherby) and/or NATS Limited (Devaney, Deakin, Fotherby, Rolfe)

Source: CAA (based on NATS Reports and Accounts)

(b) The CAA's available levers to address the potential future risks

i. NERL's access to sufficient financial and non-financial resources

- 6.9. As discussed in section 4 the CAA can provide more proactive oversight and scrutiny of NERL's annual certificate on its view on the availability of resources. There is a question as to whether the CAA should underpin this oversight with a change to the licence to require NERL when submitting its certificate to set out its assumptions and how it has sought assurance. The CAA could also ask NERL whether it has assured itself of robust contingency plans in the case of financial problems in NSL or other NATS related businesses.
- 6.10. The CAA removed a similar condition from the NERL licence in 2007 during a review of burdens in the licence. However, this was against a different risk environment and the CAA sees merit in considering its reintroduction. Consistent with a reappraisal of its risk-based approach, there is merit in the CAA increasing the resources it dedicates to scrutinising NERL in this area.
- 6.11. In addition to a licence condition requiring NERL to maintain an investment grade credit rating, the CAA has a regulatory lever in the form of a licence requirement that limits the amount of debt NERL can assume (the gearing cap). This limits debt to a level of 65% of the value of NERL's RAB. If debt is above this level NERL must present plans to the CAA for reducing it back to 65% and NERL is prohibited from distributing dividends to NATS Limited, which in turn distributes dividends to the NATS Holdings Ltd's shareholders. The CAA should continue to monitor the level of NERL's debt and its financial commitments.

Figure 6.3: NERL's debt level and the Licence gearing cap

Source: CAA

6.12. The CAA recognises that investor confidence is enhanced from having a clear and predictable understanding on how the CAA will interpret its financing duty with respect to NERL. Despite the CAA adopting various safeguards in relation to NERL's financial position to improve its resilience (such as financial ring-fencing, maintaining a minimum credit rating and a gearing cap), it is important NERL shareholders and creditors recognise that NERL's financing structure is ultimately a matter for the company. Hence its shareholders and creditors should accept the risks from the company's financing decisions without any expectation that the CAA will intervene to limit their risks through adjusting price caps once they are set. There should also be no expectation that the CAA will set future price caps in a way that will support or repair inappropriate financing structures.

ii. NERL exposure to risks arising from NATS' other group activities

6.13. NERL has never had a full ring-fence. It has always been partly derogated by the CAA granting various consents. This is because the staffing structure model predates the grant of the initial NERL licence and hence ring-fencing consents were needed from the start.

6.14. There may be merit in the CAA considering a number of options to help mitigate the risk of problems outside NERL causing problems for the regulated business.

- The CAA could undertake a detailed assessment of whether it is possible and desirable to change the NERL staffing model. This is the main underlying reason why creditors of NERL demand cross-default obligations in relation to events of financial default in other NATS business.
- The CAA could make it clear through a policy statement that it will not necessarily grant new consents when the present consents expire upon the expiry of the underlying financing facilities.

- Whilst the present consents remain in place the CAA could seek to improve its ability to monitor and respond to risks to NERL from its relationships with other NATS businesses through:
 - seeking a voluntary undertaking with NERL that it will provide the CAA with all relevant information for this purpose (e.g. when NSL seeks a parent company guarantee); and
 - considering a licence modification that obliges NERL to review and publish annually the risks and mitigations from its relationships with other NATS businesses.
 - The CAA could clarify that it has an ability to refuse granting ring-fencing consents by seeking to modify the licence to make it clear that its consents cannot be “unreasonably withheld” rather than “unreasonably delayed”. This could be supported with a requirement for NERL to demonstrate that from a user perspective the benefits of the CAA granting consents will outweigh the costs. Whilst the present consents remain in place, the CAA could seek to ensure that, if NERL effectively assumes risk to support NSL activities, it should be appropriately compensated for this.
- 6.15. The CAA also has the safeguard of Special Administration should NERL become seriously financially distressed. The Act sets out a number of provisions governing the application of Special Administration.

Figure 6.4: Key features of Air Traffic Administration Orders (Special Administration)

<p>Certain provisions apply in the case of NERL insolvency. NERL receives the following protections:</p> <ul style="list-style-type: none"> • It cannot be wound up voluntarily. • No application may be made to Court for a ‘normal’ administration order. • No party can enforce their security rights without giving the SoS and CAA 14 days’ notice.
<p>No application for winding up can be made by person other than SoS without giving SoS and CAA 14 days’ notice. If application for winding up is made then:</p> <ul style="list-style-type: none"> • SoS and CAA entitled to be heard. • No winding up order can be made nor a liquidator appointed. • But if Court would have wound up had it not been a licensed company then instead it must make an Air Traffic Administration Order (ATA Order). • The SoS and the CAA may nominate the person to manage the company whilst the Order is in effect (if they do the Court must appoint that person).
<p>Court may make ATA Order if:</p> <ul style="list-style-type: none"> • Following an application by the SoS (or the CAA with SoS consent) that: <ul style="list-style-type: none"> • Company is or is likely to be unable to pay debts; • SoS certifies it appropriate and just & equitable;

- Company has or is likely to contravene a Section 8 duty (licence holder ensures safe, efficient, co-ordinated, meets current and future demand); or
- A final or provisional order has been made in respect of Section 8 duty or a licence condition.

The purpose of ATA Order is that the person appointed by the Court will manage the licence holder's affairs to achieve:

- to transfer as a going concern as much of its undertaking as is necessary properly to carry out the licensed activities (transfers could be to one company or to several companies).
- to ensure, pending such a transfer, the continuity of the licensed activities.
- in a manner which protects the interests of the company's members and creditors.

The SoS can provide financial support whilst ATA Order is in force.

Source: CAA (based on Transport Act 2000)

6.16. In principle, the CAA supports using Special Administration if NERL becomes financially distressed especially if NERL has accepted certain risks (increased gearing) and benefited from them (such as a reduced cost of capital compared to its regulatory settlement).

6.17. The CAA recognises that Special Administration should not be considered lightly. Special Administration was not used in 2003 when various stakeholders including DfT, the CAA, the Airline Group and BAA agreed to a refinancing plan for NERL in the wake of the traffic shock caused by the events of 9/11. According to a report by the National Audit Office (NAO) in 2004 all stakeholders were keen to avoid the uncertainties that could arise from administration at that particular time. The CAA's gearing cap in the NERL licence was introduced much later in 2010.

iii. NERL governance

6.18. Economic regulators have adopted different approaches to enhancing the governance processes for regulated businesses. This reflects their varying motivations ranging from:

- responding to the development of non-traditional mixed equity/debt structures;
- the existence of regulated businesses within complex group structures;
- concerns over the strength of industry expertise on the Board of the regulated business; and
- enhancing the degree of independent scrutiny on the Board of the regulated business.

Figure 6.5: Approaches to strengthening governance

<p>Water (Ofwat) – licence obligations</p> <ul style="list-style-type: none"> • Imposed due to complex conglomerate ownership structures and non-traditional models (e.g. no equity mutuals). • 3 independent NEDs on the Appointee's (licensee's) Board who shall be persons of standing with relevant experience and collectively have connections with, and knowledge of, the areas within which the Appointee provides water services and an understanding of the interests of the customers. • The Appointee shall, at all times, conduct the Appointed Business as if it were substantially the Appointee's sole business and the Appointee were a separate plc (including applying the Code). • The composition of the Board of the Appointee should be such that the Directors act independently of the parent company or controlling shareholder and exclusively in the interests of the Appointee.
<p>Rail (ORR) – licence obligations</p> <ul style="list-style-type: none"> • Imposed to ensure industry expertise on Board. • Network Rail Board shall have majority of NEDs who shall be persons of standing and of which at least two have, to ORR's satisfaction, substantial relevant experience of railway industry. • Introduced following Railtrack admin. to avoid repeat of perceived lack of industry expertise on Board. • Must act like a plc – i.e. apply the Code.
<p>Communications (Ofcom) and Energy (Ofgem) – no licence obligations</p>

Source: CAA

- 6.19. The key principle for the CAA is to be assured that when NERL directors sit as the NERL Board, they take decisions in the best interests of NERL and they are not unduly influenced by the objectives of NATS' other business such as NSL. There may be merit in the CAA considering whether the NERL licence should include such a provision either directly or indirectly by requiring NERL to meet the requirements of the UK Corporate Governance Code. There has been such a provision in NERL's licence in the past but this was removed in 2007 following a review of the burdens imposed by the licence. Perhaps the regulatory approach that has most resonance with NERL is in relation to the independence of director(s) that do not have an interest in the wider activities of the NATS group. The Strategic Partnership Agreement (SPA) sets shareholders' rights and the CAA would consider the consequences of changes it proposes on those rights.

(c) Draft recommendations

- 6.20. **Recommendation 6:** Given that the NATS group staffing structure may have the potential to undermine the resilience of the financial ring-fencing provisions in the NERL licence, there may be merit in the CAA reviewing in more detail the pros and

cons of the present NATS group staffing structure. It would be valuable if such a review considered whether or not the balance of argument and evidence favoured requiring NERL to have its own staffing resources within its ring-fenced business rather than having to contract for staff resources with NATS Limited.

- 6.21. **Recommendation 7:** Whilst the present NERL ring-fencing consents remain in place there are a number of steps the CAA could consider to more effectively scrutinise the inherent risks arising from the weakened financial ring-fence. These include seeking voluntary undertakings from NERL that it will provide the CAA with certain information and the CAA considering proposing a licence modification to oblige NERL to proactively review and publish the risks to its business from its relationships with NSL and other NATS businesses. The CAA could also consider a licence modification to strengthen its process for granting and refusing ring-fencing consents. These steps could be in addition to the CAA being more proactive in monitoring NERL's financial position and increasing its regulatory scrutiny of NERL's annual certificate of available resources (recommendation 2). Finally, there may be merit in the CAA considering a licence modification to support this enhanced financial oversight of NERL's annual certificate by requiring it to set out its assumptions and how it has gained assurance.
- 6.22. **Recommendation 8:** Given the importance of NERL having effective governance there may be merit in the CAA seeking a licence modification to strengthen the assurance it can derive that NERL directors will put the objectives of NERL before the objectives of NSL and other NATS business interests. For example, this might require NERL to apply the UK Corporate Governance Code and appoint one or more independent non executive directors (NEDs) that do not have interests in NSL and other NATS businesses.

7. Strategic capabilities for the future

Draft strategic outcome:

NERL (and NSL) play their full part in developing the strategic capabilities necessary to deliver their contribution to FAS, including improving environmental outcomes by making more efficient use of airspace

(a) Potential future risks to achieving the CAA's strategic outcome

i. Clarity on accountabilities

7.1. The delivery of FAS requires effective collaboration from a wide range of parties. It is important that there is no lack of clarity on roles and responsibilities that could risk confusion and tension. This would ultimately risk effective implementation of FAS and in turn the UK's contribution to the deployment of SESAR and its other obligations under SES legislation.

ii. NERL's and other parties' commercial incentives to deliver FAS

7.2. The CAA will need to continue to exercise leadership to ensure that the industry collaborates effectively to deliver FAS. CAA leadership and influence is important given the CAA has few formal levers to require parties to deliver certain actions necessary to achieve the FAS vision. Under the ANO the CAA has certain powers of Direction over ANSPs and can mandate the carriage of certain equipment on aircraft. However, these CAA powers are designed to be used in extreme circumstances.

Figure 7.1: Overview of FAS stakeholders



Source: CAA

- 7.3. NERL and NSL have significant roles to play in the implementation of FAS. The main risk is if they do not consider there are pressing commercial imperatives to play their full and active part and hence the implementation of FAS is put in jeopardy or else significantly delayed.
- 7.4. NERL's commercial incentives could be weakened if it perceives that the present value of costs to its business exceed the present value of benefits to its business (as compared to the costs and benefits from a broader industry point of view, which may be the perspective of the CAA). This could be the case if:
- NERL does not have sufficient confidence in the timing, scale or robustness of the future benefits and/or if the costs are high (including the opportunity cost of using staff and capital resources on FAS initiatives); and
 - the benefits from FAS initiatives accrue to third parties such as airlines rather than NERL. In this case there is a question of whether the CAA should seek to compensate NERL through allowances in its price controlled charges to en route users as far as is compatible with the Performance Scheme.
- 7.5. Users will also be mindful of a further risk if NERL does not have robust mechanisms to deliver projects at the most efficient cost and filter out projects that do not have a positive net value. This risk might be accentuated if NERL is raising the funding from its monopoly en route business or is in receipt of public funding.
- 7.6. It is therefore important the CAA understands the business case for FAS initiatives both from a NERL perspective and an industry wide perspective.
- 7.7. Annex II sets out an overview of FAS related initiatives.
- 7.8. It should be recognised that the UK controlled airspace system is an integral part of the European ATM network and cannot operate in a vacuum. The FAS will need to take full account of the relevance and impact of European developments on UK controlled airspace and will need to facilitate alignment and integration with key initiatives. In particular, the FAS considers the alignment with the main strands of the SESAR programme, the development of FABs, the Network Management Function and Performance Scheme of the SES as well as EASA rule making. To allow for effective implementation of the proposals led by the FAS, the UK needs to understand the balance between decisions taken at the European level and those taken nationally, and the interactions between the two. It is important that FAS is compliant with other EU airspace initiatives and does not drive the UK in a direction that is in conflict with greater integration across Europe in its widest sense rather than just with the other EU Member States. The FAS will form the national contribution to SESAR. Whilst FAS is a national strategy it was drawn up fully in the context of emerging European and other international requirements and was entirely consistent with what were known to be the emerging themes.

(b) The CAA's available levers to address the potential future risks*i. Clarity on accountabilities*

7.9. To help mitigate the risks from unclear accountabilities the CAA should collaborate with stakeholders to map roles and responsibilities for airspace developments such as LAMP. This can clarify what different players should be expected to deliver. The CAA can continue to exercise a leadership role with stakeholders through its position on the LAMP programme Board and through the FAS Industry Implementation Group (FASIIG).

ii. NERL's and other parties' commercial incentives to deliver FAS

7.10. Given CAA has very limited formal powers of Direction under the ANO, the CAA will need to continue to encourage effective industry collaboration through the FASIIG with a focus on realising early benefits. These include:

- early initiatives to improve airspace efficiency through improving queue management, reducing stack holding, improving climb performance and airport Collaborative Decision Making (CDM);
- NERL developing plans to deliver LAMP in a timely way based on revised Transition Altitude and Performance Based Navigation;
- the UK/Ireland FAB continues to deliver benefits in terms of direct/free-route airspace in line with the SESAR Concept of Operations (Conops); and
- the development of new tools to enable flexible and dynamic use of airspace to ensure capacity demands are met where and when required.

7.11. The FASIIG are under a remit to produce a FAS Implementation Plan by the end of 2012. This can then be used as a key input for the CAA's next review of the NERL price control to ensure that necessary programmes are included at efficient costs and users have an ability to scrutinise NERL's plans. The CAA may need to consider whether it can better align and sharpen NERL's commercial incentives to deliver FAS through regulatory incentives within the RP2 of the Performance Scheme.

7.12. There may be merit in promoting this FASIIG approach in the context of European SESAR implementation to provide further support to the alignment of stakeholder investment plans based on a robust appraisal of the risks and benefits.

7.13. To the extent that FAS initiatives should be led by airports, the CAA may also be able to use incentives within the price controls it sets for regulated airports. However, these price controls currently only cover a sub-set of the London airports (Heathrow, Gatwick and Stansted). This lever is not, therefore, available for airports where the CAA does not set economic regulation, and where the CAA will need to rely on its influence working in collaboration with the relevant stakeholders.

7.14. There are also international collaborations in which NERL is obliged to participate. For these obligations, it is important that NERL participates in an efficient manner,

regardless of whether there is a positive business case from NERL's individual perspective. Such collaborations are expected to deliver net benefits from an EU-wide perspective.

(c) Draft recommendations

- 7.15. **Recommendation 9:** Given that significant industry wide collaboration is needed to deliver FAS initiatives, there may be merit in the CAA, through FASIIG, developing a clear map of accountabilities and responsibilities of the various players so all stakeholders are clear what is expected, from whom, and by when.
- 7.16. **Recommendation 10:** There may be merit in the FASIIG plan being a key input to the CAA's next NERL price control review so that economic regulation can support efficient, timely and effective delivery of FAS initiatives. To help with this there may also be merit in the CAA gaining a better understanding of the business case of various FAS initiatives from both a private NERL perspective and a wider industry perspective in order to consider whether NERL's commercial incentives to deliver certain initiatives should be strengthened in the next price control settlement.

8. Clarity on regulatory obligations

Draft strategic outcome:

There is clarity on NERL's regulatory obligations and relationships with the CAA

(a) Potential future risks to achieving the CAA's strategic outcome

i. Ambiguities in the NERL licence

- 8.1. A number of recent CAA interactions with NERL have highlighted ambiguities in the NERL licence over the scope of its obligations with respect to certain types of service provision contained within the Specified Services. This includes recent discussions about the removal of Class F airspace, NERL's plans to rationalise its portfolio of VHF Omnidirectional Radios (VORs), and discussions about the future of the Air Traffic Services Outside Controlled Airspace (ATSOCAS). A lack of clarity in regulatory obligations can lead to confusion, tension and unclear accountabilities which risks sub-optimal outcomes for users.

Figure 8.1: Overview of the Specified Services

Infrastructure services
<ul style="list-style-type: none"> • Aeronautical Messaging Network • Air Traffic Operational Telephone Network • Navigational infrastructure services • Surveillance infrastructure services
Flight information services
<ul style="list-style-type: none"> • North Sea Helicopter advisory service • UK Aeronautical Information Service • UK Flight Information Service • UK Meteorological Information Service
Emergency services
<ul style="list-style-type: none"> • Emergency fixing facility • Emergency frequency facility

Source: CAA

- 8.2. If there is ambiguity and uncertainty there is a risk that NERL could seek to make a change to enhance its cost-efficiency but in doing so remove or alter a service that the CAA considers is intrinsic to NERL discharging its obligations under the licence or that underpins a CAA requirement or state obligation.

8.3. The CAA has recently been requested to provide guidance on the interpretation of the non-discrimination provisions in the NERL licence in relation to possible congestion and disruption caused by the London Olympics.

ii. Alignment of UK and European legislation

8.4. With the increasing development of legislation and regulation at the European level it is important that all stakeholders have a clear understanding of where the EU has established legal competence. It is also important that the CAA and DfT have an understanding on the areas where the UK and EU requirements may be misaligned. This is more important than it has been in the past owing to the development of more detailed EU legislation over the past few years. Ambiguities can lead to regulatory uncertainty.

iii. Confusion over the nature of the CAA/NERL interface

8.5. The CAA has a complex and multi-faceted relationship with NERL. This relationship cuts across a number of CAA functions including safety regulation, airspace policy, and economic regulation. It is also a relationship with much history: NATS and the CAA were previously within the same organisation until 2000.

8.6. The nature of the regulatory interfaces also varies from case to case. In many instances it is a formal regulatory relationship with the CAA holding NERL to account for delivering its regulatory obligations. Sometimes the interface is characterised more by a collaborative approach where both organisations need to work effectively together for the greater good, for example when it comes to developing the plans to implement FAS. However, if the nature of the regulatory relationship is not clear there is a risk of confused accountabilities and regulatory capture. This can ultimately weaken the effectiveness of the regulatory system to achieve its goals.

(b) The CAA's available levers to address the potential future risks

i. Ambiguities in the NERL licence

8.7. The CAA has the ability to review the licence obligations in relation to the Specified Services, including VORs and ATSOCAS. Terms of reference have recently been agreed between the CAA and NERL for this purpose.

8.8. In relation to non-discrimination, the licence already goes some way to amplifying this principle. There is perhaps merit in avoiding specifying on the face of the licence too much detail about how this principle should be interpreted. This is because the variety of circumstances in which non-discrimination is important is broad and a complete range of scenarios would be difficult and counter-productive to define in advance. Nevertheless, where a scenario gives rise to a need for the CAA to provide further guidance this can be done in light of the circumstances and facts prevailing at the time as has been the case recently with the airspace

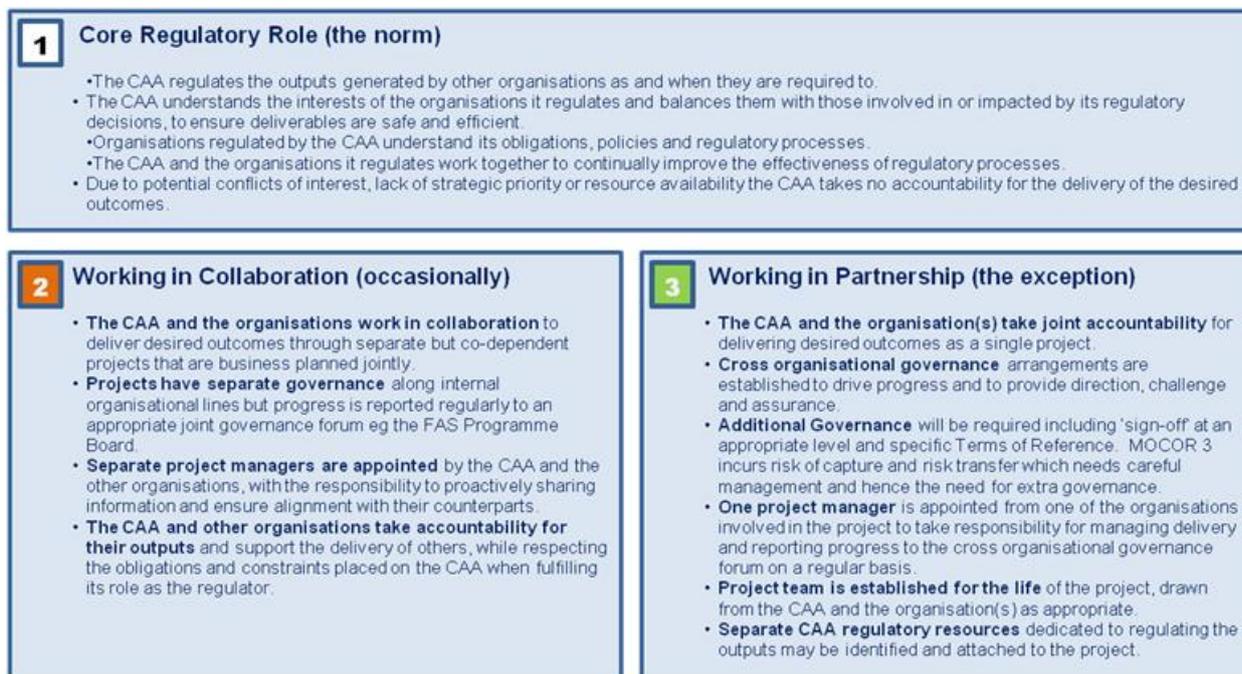
prioritisation approach during the Olympics. This approach is similar to that adopted by other regulators with non-discrimination conditions in the licence(s) of regulated companies.

ii. Alignment of UK and European legislation

- 8.9. There is merit in the CAA discussing with the DfT and other stakeholders the scope of national ATM legislation where the EU has a legal competence and the extent to which the UK needs to align any currently disparate legislation and other requirements.
- 8.10. In this regard it should be noted that one of the provisions in the Civil Aviation Bill, currently being considered by Parliament is to bring the CAA's regulation of NERL within the ambit of the Regulatory Enforcement and Sanctions Act 2008. This will put the CAA under an obligation to avoid imposing or maintaining unnecessary burdens.
- 8.11. There is merit in any CAA/DfT discussions on the future of ATM legislation exploring the merits of extending to the CAA the power to impose civil sanctions and penalties to support a more graduated and proportionate enforcement regime (see paragraph 4.10).

iii. Confusion over the nature of the CAA/NERL interface

- 8.12. The CAA should have an agreed framework for understanding the type of regulatory relationship it has with NERL (and NSL). It has developed an approach based on the Maturity of Cross-Organisational Relationships framework (MOCOR). This is being rolled out across the CAA to ensure a consistent application across the various CAA groups. This sets out a clear basis for the regulatory engagement with NERL (and NSL).

Figure 8.2: Overview of the CAA's MOCOR framework

Source: CAA

(c) Draft recommendations

- 8.13. **Recommendation 11:** Transparency and certainty on regulatory obligations are prerequisites for an effective regulatory regime. Given that it is accepted between the CAA and NERL that the licence contains some ambiguities that could give rise to confusion and tension, there is merit in the CAA and NERL continuing to undertake a structured review of the Specified Services with a view to clarifying the nature and scope of these obligations. In addition, given that the CAA's relationships with NERL are multi-faceted across its various regulatory functions such as airspace policy, safety regulation and economic regulation, it is important that each interface has a clear purpose and understood roles and responsibilities. There may be merit in the CAA continuing to roll out throughout its organisation its MOCOR framework and encouraging NERL to do likewise.
- 8.14. **Recommendation 12:** There may be merit in the CAA discussing with DfT those instances where the UK framework has been rendered out of date and misaligned with the passing of EU legislation, with a view to remedying this at the earliest opportunity. There may also be merit in the CAA discussing with DfT whether granting powers to the CAA to impose civil sanctions and penalties would lead to an enforcement regime that is more targeted and proportionate.

9. Ownership neutrality

Draft strategic outcome:

CAA in undertaking its regulatory functions can be neutral with respect to the ownership of NERL as it has sufficient regulatory levers to achieve its objectives

(a) Potential future risks to achieving the CAA's strategic outcome

- 9.1. The CAA has no ability to control who owns NERL so it needs to ensure that its regulatory framework does not depend on a particular form of ownership.
- 9.2. This approach is similar to other economic regulators, which tend to be neutral to the ownership of the regulated business. Economic regulators tend to concentrate on outcomes such as price and service quality and develop incentive mechanisms that align the regulated company's profit maximisation objectives with desired regulatory outcomes.
- 9.3. To meet this aim the CAA has to assure itself that it does not rely inappropriately on a particular ownership or shareholding structure to mitigate certain risks. It would also give rise to regulatory uncertainty and potential policy shocks if the nature of regulation depended upon ownership at a point in time.

(b) The CAA's available levers to address the potential future risks

- 9.4. This ad hoc review is designed to provide the CAA with assurance that its regulatory framework does not rely inappropriately on a particular form of ownership.
- 9.5. NERL financial distress could lead to negative outcomes for users. Hence it is important CAA gains assurance from the effectiveness of *ex ante* safeguards, as well as the *ex post* safeguard of Special Administration.
- 9.6. The principal *ex ante* safeguard is the resilience of the financial ring-fence in the NERL licence in addition to the requirements around gearing (debt) levels and the maintenance of an investment grade credit rating. As discussed in detail in section 6, the current licence ring-fence has effectively been weakened by the CAA granting various consents to NERL allowing it to accept certain financing obligations such as cross-default obligations.
- 9.7. The context of the CAA wanting to be neutral to NERL ownership whilst a weakened financial ring-fence remains in place might help to reinforce the merit of the CAA taking a more proactive approach to its assessment of NERL's certificate on its adequacy of resources. The certificate is important because it covers more than just financial resources. It extends amongst other things to assets, systems, people and management resources. The options for the CAA's scrutiny of NERL's annual

certificate and the CAA's draft recommendations in this area are explained more fully in section 6.

- 9.8. The CAA is mindful that the current NATS PPP ownership structure gives the government a higher degree of influence over the regulated business compared with other UK regulated businesses where it is not a shareholder. The SPA among NATS shareholders sets out certain rights and obligations among the parties. For example, the SPA enables the Airline Group to exercise the majority of voting rights on the NATS Holdings Ltd Board. The SPA enables the government to appoint three non executive Board directors and requires the government to give its consent to shareholders disposing of all or part of their equity in NATS Holdings Ltd.
- 9.9. The NATS PPP model is, however, unique among en route ANSPs in the EU. The common model is for the en route ANSP to be fully owned and financed by the government and for the government to have a significant ability to influence the ANSP via direct and indirect mechanisms.
- 9.10. Aside from its role as a shareholder in NATS Holdings Ltd, the government has certain powers either directly in the Act or via the NERL licence. For example, it has the ability to revoke the NERL licence if it considers that a change of ownership would have adverse effects on national security or the UK's international relations. The government may also alter a term of the NERL Licence in relation to its scope, duration and revocation (as compared to conditions of the NERL licence such as the price control, which are modified by the CAA). The government can veto a licence modification proposed by the CAA and can halt a CAA reference to the Competition Commission.

10. Draft recommendations

10.1. Views are especially welcome from stakeholders on whether:

- the CAA's draft strategic outcomes for its regulation of NERL are appropriate; and
- the CAA's draft recommendations represent a targeted and proportionate set of responses best designed to help the CAA achieve the draft strategic outcomes and mitigate potential risks.

Figure 10.1: Summary of draft recommendations

Draft recommendations	
1.	The future is inherently uncertain so there is merit in the CAA continuing to adopt a risk-based approach to its regulation of NERL. There is also merit in it periodically reviewing its regulatory framework to ensure that it remains consistent with Better Regulation Principles.
2.	The CAA should ensure that NERL continues to enhance its strategic safety risk capability. This includes the mitigation of total systems risks and tackling longer-term risks arising from traffic, congestion and technology trends. NERL needs to articulate its approach through Business Plans required under the EASA Common Requirements. There may be merit in the CAA subjecting these plans to increased regulatory oversight and scrutiny. There may also be merit in the CAA subjecting to increased oversight and scrutiny NERL's annual certificate on its availability of resources as this goes beyond financial resources and includes systems, staffing, management resources, etc.
3.	NERL is increasingly collaborating with international partners and NSL is seeking more commercial contracts in the UK and abroad. The CAA should continue to work with other Competent Authorities to ensure that NERL's technical collaborative arrangements with other ANSPs and equipment suppliers contribute to improving UK safety and do not have negative effects on NERL.
4.	The CAA should ensure that its price control for NERL in RP2 makes sufficient contribution to the achievement of the European Commission's EU-wide targets, including on cost-efficiency. NERL must prepare to respond positively to the European Commission targets and the level of contribution that will be expected. As a first step NERL should prepare a business plan that is based on CAA scenarios for expectations of the EU-wide cost-efficiency targets. Any deviations should be evidenced and soundly justified by NERL to persuade users, the CAA, the PRB and the European Commission.
5.	With users expecting NERL to contribute to improving total economic cost - whilst ensuring it remains focused on raising its game on cost efficiency - there may be merit in the CAA working with industry, its FAB partners, and the PRB, to explore and promote more intelligent ways of measuring the inter-dependencies between various key performance areas.

Draft recommendations (continued)

6. Given that the NATS group staffing structure may have the potential to undermine the resilience of the financial ring-fencing provisions in the NERL licence, there may be merit in the CAA reviewing in more detail the pros and cons of the present NATS group staffing structure. It would be valuable if such a review considered whether or not the balance of argument and evidence favoured requiring NERL to have its own staffing resources within its ring-fenced business rather than having to contract for staff resources with NATS Limited.
7. Whilst the present NERL ring-fencing consents remain in place there are a number of steps the CAA could consider to more effectively scrutinise the inherent risks arising from the weakened financial ring-fence. These include seeking voluntary undertakings from NERL that it will provide the CAA with certain information and the CAA considering proposing a licence modification to oblige NERL to proactively review and publish the risks to its business from its relationships with NSL and other NATS businesses. The CAA could also consider a licence modification to strengthen its process for granting and refusing ring-fencing consents. These steps could be in addition to the CAA being more proactive in monitoring NERL's financial position and increasing its regulatory scrutiny of NERL's annual certificate of available resources (recommendation 2). Finally, there may be merit in the CAA considering a licence modification to support this enhanced financial oversight of the NERL's annual certificate by requiring it to set out its assumptions and how it has gained assurance.
8. Given the importance of NERL having effective governance there may be merit in the CAA seeking a licence modification to strengthen the assurance it can derive that NERL directors will put the objectives of NERL before the objectives of NSL and other NATS business interests. For example, this might require NERL to apply the UK Corporate Governance Code and appoint one or more independent non-executive directors (NEDs) that do not have interests in NSL and other NATS businesses.
9. Given that significant industry wide collaboration is needed to deliver FAS initiatives, there may be merit in the CAA, through FASIIG, developing a clear map of accountabilities and responsibilities of the various players so all stakeholders are clear what is expected, from whom, and by when.
10. There may be merit in the FASIIG plan being a key input to the CAA's next NERL price control review so that economic regulation can support efficient, timely and effective delivery of FAS initiatives. To help with this there may also be merit in the CAA gaining a better understanding of the business case of various FAS initiatives from both a private NERL perspective and a wider industry perspective in order to consider whether NERL's commercial incentives to deliver certain initiatives should be strengthened in the next price control settlement.

Draft recommendations (continued)

11. Transparency and certainty on regulatory obligations are prerequisites for an effective regulatory regime. Given that it is accepted between the CAA and NERL that the licence contains some ambiguities that could give rise to confusion and tension, there is merit in the CAA and NERL continuing to undertake a structured review of the Specified Services with a view to clarifying the nature and scope of these obligations. In addition, given that the CAA's relationships with NERL are multi-faceted across its various regulatory functions such as airspace policy, safety regulation and economic regulation, it is important that each interface has a clear purpose and understood roles and responsibilities. There may be merit in the CAA continuing to roll out throughout its organisation its MOCOR framework and encouraging NERL to do likewise.
12. There may be merit in the CAA discussing with DfT those instances where the UK framework has been rendered out of date and misaligned with the passing of EU legislation, with a view to remedying this at the earliest opportunity. There may also be merit in the CAA discussing with DfT whether it granting powers to the CAA to impose civil sanctions and penalties would lead to an enforcement regime that is more targeted and proportionate.

Annex I: Glossary

AG	Airline Group (NATS shareholder)
ANO	Air Navigation Order
ANSP	Air Navigation Service Provider
ATAO	Air Traffic Administration Order
ATCOs	Air Traffic Controllers
ATM	Air Traffic Management
ATSOCAS	Air Traffic Services Outside Controlled Airspace
CDM	Collaborative Decision Making
CONOPS	Concept of Operations
DfT	Department for Transport
DUR	Determined Unit Rate
EASA	European Aviation Safety Agency
EUROCONTROL	European Organisation for the Safety of Air Navigation
FABs	Functional Airspace Blocks
FAS	Future Airspace Strategy
FASIIG	Future Airspace Strategy Industry Implementation Group
IAA	Irish Aviation Authority
ICAO	International Civil Aviation Organisation
LAMP	London Airspace Management Programme
MOCOR	Maturity of Cross Organisational Relationships
NAO	National Audit Office
NED	Non Executive Director
NERL	NATS (En Route) plc
NLMCC	The CAA's NERL Licence Management Coordination Committee
NPP	National Performance Plan
NSA	National Supervisory Authority
NSL	NATS (Services) Limited
PPP	Public Private Partnership
PRB	Performance Review Body
RP1/2	Reference Period 1 (2012-2014) and 2 (2015-2019)
SES	Single European Sky
SESAR	Single European Sky ATM Research Programme
SMS	Safety Management System
SoS	Secretary of State
SPA	Strategic Partnership Agreement
VORs	VHF omnidirectional radio (a radio navigation system for aircraft)

Annex II: Overview of FAS related initiatives

Each FAS operational improvement is enabled by a combination of ATM capabilities that require joined-up investment across key stakeholder groups.



Benefit Case	Phase of flight	FAS Operational Improvement	Stakeholders Impacted	ATM Capabilities Required
En route	Cruise	More direct routes in the upper airspace	<ul style="list-style-type: none"> Commercial, Military and GA Aircraft En route ANSP Network Management Airline Flight Planning 	<ul style="list-style-type: none"> B1. Procedure Redesign in the upper airspace E2. Communication and Surveillance E3. Enhanced ATC Toolsets F1. Collaborative Network Management
		Free routeing through volumes of upper airspace	<ul style="list-style-type: none"> Commercial, Military and GA Aircraft En route ANSP Network Management Airline Flight Planning 	<ul style="list-style-type: none"> B1. Procedure Redesign in the Upper Airspace E2. Communication and Surveillance E3. Enhanced ATC Toolsets F1. Collaborative Network Management F2. Weather Resilience
		Better management of special use airspace	<ul style="list-style-type: none"> Commercial, Military and GA Aircraft En route ANSP Network Management Airline Flight Planning 	<ul style="list-style-type: none"> B1. Procedure Redesign in the Upper Airspace B2. Enhanced Flexible Use of Airspace F1. Collaborative Network Management F2. Weather Resilience
		Sequencing en route traffic to arrive in an optimal order, on time and on schedule	<ul style="list-style-type: none"> Commercial Aircraft En route ANSP Airports 	<ul style="list-style-type: none"> C. Queue Management D1. Airport Collaborative Decision Making E2. Communications and Surveillance
Terminal	Descent	More continuous climb sections	<ul style="list-style-type: none"> Commercial, Military and GA Aircraft Terminal ANSP 	<ul style="list-style-type: none"> A. Terminal and Airport Procedure Re-design C1. Arrival Management C2. Departure Management E1. Performance Based Navigation

	Climb	Reduced stack holding and more continuous descents	<ul style="list-style-type: none"> Commercial, Military and GA Aircraft Terminal ANSP 	<ul style="list-style-type: none"> A. Terminal and Airport Procedure Re-design C1. Arrival Management C2. Departure Management E1. Performance Based Navigation
	Descent & Climb / First Turn	More systemised arrival & departure routes	<ul style="list-style-type: none"> Commercial and Military Aircraft Terminal ANSP 	<ul style="list-style-type: none"> A. Terminal and Airport Procedure Re-design C2. Departure Management E1. Performance Based Navigation E3. Enhanced ATC Toolsets
Runway Optimisation	Final Approach & Landing / Take off	Greater slot adherence / utilisation	<ul style="list-style-type: none"> Airline Flight Planning Commercial Aircraft Airport ANSP Airport 	<ul style="list-style-type: none"> A. Terminal and Airport Procedure Re-design D1. Airport Collaborative Decision Making D2. Surface Management F2. Weather Resilience
	Final Approach & Landing / Take off	More precise flight paths and closer approach spacing in certain conditions	<ul style="list-style-type: none"> Commercial and Military Aircraft Terminal ANSP Airport ANSP 	<ul style="list-style-type: none"> A. Terminal and Airport Procedure Re-design E1. Performance Based Navigation E3. Enhanced ATC Toolsets
	Taxi-in, Turnaround, Taxi Out	Less time spent taxiing and queuing on the airfield	<ul style="list-style-type: none"> Commercial Aircraft Airport ANSP Airport 	<ul style="list-style-type: none"> C2. Departure Management D1. Airport Collaborative Decision Making D2. Surface Management

Source: CAA

