



**Response to the CAA  
Firm Proposals for the NATS  
CP2 Review**

**29 July 2005**

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## Executive Summary

Whilst welcoming a number of elements of the CAA's firm proposals for CP2 they are, in aggregate, a move towards a more generous settlement for NATS than those presented in the CAA's initial proposals.

We support the CAA's proposals to:

- extend the price control to cover the London Approach services
- move from CSUs to distance as the traffic metric for NATS
- retain the current correction mechanism
- treat under (over) recoveries as at 31 December 2005 in the revenues allowed for CP2.

However, in a number of areas the CAA proposals do not challenge NATS strongly enough to improve performance. In particular, the CAA has :

- opted for service quality metrics which appear less challenging than even its current actual level of performance
- provided NATS with its full capex allowance with limited safeguards for users in the event of under delivery even though NATS has a history of under delivery and the current investment plan is more ambitious than previous ones.

These measures serve to reduce the level of risk faced by NATS. Yet the CAA has increased the risk element of the cost of capital to a point that is, in effect, higher than the risk element allowed in CP1 when it could be argued that NATS faced more risk than it does now. This raises concerns about the balance that is struck when allowing for risk in regulatory decisions.

In view of the concerns that we highlight in our response we urge the CAA to establish an annual review of the performance of NATS against the expectations of the CP2 settlement.

## **1.0 Introduction**

- 1.1 This submission sets out the position of British Airways (BA) in response to the CAA's Firm Proposals for the regulatory settlement of the NATS Price Control Review for the second regulatory period CP2. It addresses the subject areas in the same order as presented by the CAA in their firm proposals consultation document.
- 1.2 It was recognised that the CAA's initial proposals equated to a price cap in traditional terms of RPI-5. NATS indicated in the oral hearings that they had made an effort to accommodate this and felt able to deliver the business requirements with a price cap of RPI-4. It is therefore surprising that the CAA have now proposed a price cap that equates to RPI-3. This does not seem likely to incentivise NATS to progress down the road of continual improvement they indicated they were committed to in the oral hearings.
- 1.3 We believe that in aggregate the proposals of the CAA have the effect of reducing the level of risk faced by NATS and at the same time allowing them to earn higher returns. We remain of the view that NATS has room to improve its performance and should be challenged to do so. Therefore, we think it would be inappropriate for the CAA's firm proposals to be classified as stretching for NATS and on the basis of our analysis believe that NATS should have no difficulty in accepting them.

## **2.0 Scope of Control**

- 2.1 We welcome the CAA's proposal to extend the price control to cover the London Approach service and that the CAA is proposing to ensure that NATS does not make London Approach charges less cost reflective. As per our previous submission in February, users will get some comfort to have transparency of this process. The annual NATS unit rate consultations with users would be an opportunity to do this.
- 2.2 We welcome the CAA's recognition of the importance of ensuring that the MOD and other customers of NATS non-regulated businesses pay their full share of NATS costs to avoid a situation in which commercial air transport subsidises other activities. We look to the CAA to establish a robust method for doing this.

## **3.0 Structure of Control**

### ***Fixed / Variable Split and Traffic Metric***

- 3.1 The 50% fixed/ 50% variable split continues to protect NATS from volume risk and should be viewed in the total context of the CAA's firm proposals. The volume risks borne by NATS will be further reduced as a result of removing weight from the NATS revenue by moving to a distance travelled metric from the existing CSUs. BA continues to support the principle of removal of aircraft

weight from all calculations including the charging mechanism, because of its insignificance as a cost driver. However, it should also be noted that NATS volume risks are reducing from the current situation. NATS has indicated that for 04/05 “north atlantic flight volumes grew by 4.3% recovering close to pre-9/11 levels”.<sup>1</sup>

### ***Smoothing Volatility in Charges***

- 3.2 BA welcomes the CAA’s proposal to retain the current recoveries mechanism by ensuring that adjustments are kept as close as possible to the time of consumption of the services.

### **CAA/DfT Element of the Correction Factor**

- 3.3 The CAA firm proposal on this leaves users exposed. Whilst it is reasonable to assume NATS does not have direct control over many of the costs concerned they are the consumers of the meteorological services. Therefore they are in a position to agree their service requirements which inform the costs borne by users. The current process of notifying users of the costs associated with these services appear to be as a fait accompli for the CAA/DfT component at the annual NATS unit rate consultations. The question remains about who is accountable to users for demonstrating that the services provided under the CAA/DfT umbrella are done so in a cost effective manner.

### **Treatment of Under/(Over) Recovery as at 31 December 2005**

- 3.4 BA considers that any adjustments made at the end of the existing control period should be through revenues as this means the impact of this adjustment is for a relatively shorter period of time than through the RAB.

## **4.0 Traffic Forecasts**

- 4.1 The CAA has not changed the traffic forecasts used to develop its initial proposals, which we broadly supported. We do not have any further comments on the proposed traffic forecasts, and we are therefore broadly content with the traffic volume assumptions used to support the CAA’s firm proposals.

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<sup>1</sup> NATS press release of 01 July 2005

## 5.0 Service Quality

### General Principles

- 5.1 We welcome the CAA's intention to strengthen the delay term. The service provided by NATS is, essentially, the sequencing of aircraft into efficient and expeditious flows of air traffic. If any flows are interrupted, diverted or slowed down, delays and cancellation result, causing immense costs to airlines and passengers. In other words, the value of the service depends on how efficient NATS can make the flow, without, of course, compromising safety.
- 5.2 Delay is not the only dimension of service quality. In our previous response we drew attention to other important measures, including Minimum Departure Intervals (MDIs) and suggested that rather than creating new financial incentives in these areas, NATS should be encouraged to report on these measures in the monthly Condition 11 report so that progress could be tracked against them. This would also make it less likely that delay performance was improved by compromising the other dimensions of service quality.
- 5.3 Our main concern with the CAA's proposal is that the standard is set at the wrong level and this means that the objective of strengthening delay incentives will not be met. Instead, airlines will be paying NATS large "performance" bonuses. This is discussed below, under the CAA's headings.

### Safety

- 5.4 We agree with the CAA that this term does not compromise safety. Airlines already face much larger costs than NATS if flights are delayed for technical reasons, but there is no evidence that this has compromised airline safety. None of the ingredients of operational safety will be affected by the term – safety standards, the training of staff, the formal responsibilities or the use of a safety management system to detect problems. We also do not believe that NATS as a company, or its staff, would be willing to compromise safety for short term financial gain.
- 5.5 In fact, a stronger delay term should enhance safety because it is designed to incentivise NATS to plan ahead effectively, so that sufficient capacity will be available in the right place and at the right time to meet future traffic levels. NATS will also need to build in more operational flexibility for dealing with inevitable uncertainties and variations in demand. This would reduce the number of occasions when traffic must be regulated to prevent overloading individual controllers.

### "Expected" Performance and the Par Value

- 5.6 The term "expected performance" is ambiguous. It is unclear whether this is essentially a *forecast* level of likely performance, or whether it is supposed to denote a *standard* of acceptable performance as defined by the economic regulator. It seems to be the former, but it is also likely to be interpreted as the acceptable standard of performance. This is because the CAA intends to

set the “par value” at the same level as the “expected” level. While the term “par value” is also ambiguous, it does imply a performance standard that should be achieved. It is very unhelpful to set this standard so far from the level required by users, with no improvements over CP2 (even gradual or symbolic improvements, as in CP1). It is disappointing that the CAA has proposed this value without making any attempt to ascertain the acceptable level of delay performance, except by looking at the SIP which is written by NATS from its own perspective.

- 5.7 We do not agree that 0.5 minutes should be seen as a “stretch target”. NATS has for many years used 1 minute as a long term target, despite consistent and strong pressure from users every year in the SIP consultations to reduce towards a level that reflects the needs and expectations of airlines. Because of this pressure, NATS has reduced the target to 30 seconds by planning high levels of capex and opex which are to be funded through the price cap. It was only the prospect of this performance improvement that caused airlines to support such a high level of investment. No other level of service was discussed because longer delays would have been associated with a lower level of investment – and therefore lower prices.
- 5.8 By calling this a stretch target, we believe NATS is referring to traffic volume risks and investment risks. These risks are, however, already “funded” through the price cap and should not be funded again through the service quality term.
- 5.9 Users should, therefore, be entitled to expect that the improved performance we will be paying for through the price cap will be delivered in practice. Under the CAA’s proposals, we would have to pay NATS twice:
- once for the cost of putting the additional capacity in place (including a profit reflecting the risks); and
  - a second time when they achieve the improved performance and will be rewarded with large ongoing bonus payments under the service quality term.
- 5.10 If NATS does not achieve the improvement in performance, airlines will be paying higher prices associated with the investment programme without receiving the performance benefit that justified the investment. This is inequitable. The service performance standard should be set at the level needed by users, commensurate with the outputs of the investment programme.
- 5.11 In addition, the CAA should not have regard to historically poor performance levels over the past eight years in deciding where to set the standard. NATS had a serious problem with delays in the period before (and immediately after) the NERC was installed at Swanwick, caused by the long delays in implementing the system, and the stop gap measures that had to be taken to manage the performance crisis (for example the splitting of the Clacton sector). It was recognised when the CAA first set the performance target that a very loose standard had to be set in CP1 to reflect NATS’ current performance problems, and the uncertainties involved in implementing

Swanwick. The intention was to allow NATS time to recover its performance. By including this period of abnormally poor performance, and by excluding 2004, which was a good year, the CAA has concluded, wrongly, that 45 seconds passes the test of historic reasonableness.

- 5.12 To assess whether its standard is reasonable, the CAA should also have regard to the Eurocontrol Performance Review Commission reports, which show
1. that NATS' delays are worse than the European average; despite the high prices; and
  2. that the optimum level of delay, taking account of delay costs and capacity costs, is about 0.3 minutes/sector.
  3. After much discussion, the Provisional Council have set a performance target *per flight* of 1 minute by 2006, which is equivalent to about 0.3 minutes/sector. The UK should consider itself committed to this target, and this will require NATS to at least maintain its current level of performance.
- 5.13 It is therefore clear that the performance standard should be set at no more than 30 seconds. This is still above levels demonstrably achievable by NATS and by other comparable ANSPs. It also takes proper account of traffic levels and the investment programme. Finally it would also be consistent with the Eurocontrol performance target<sup>2</sup>.
- 5.14 Under current proposals, airlines will have to pay higher prices *and* performance bonuses, even if delays rise to almost double current levels. That would be unjust.

### **Scale of the Incentive**

- 5.15 If the delay standard were to be set at 45 seconds, almost double current levels, this term would be much more likely to result in airlines paying additional money to NATS rather than NATS refunding users. This makes it even more unlikely that the "ceiling" would ever be reached.
- 5.16 In 6.34, the CAA acknowledges in principle our argument about there being no case for a ceiling, because long delays are most likely to result from high traffic volumes, when NATS would be in receipt of surplus revenues. It is true that long delays occurred in 2002 after the introduction of Swanwick when traffic levels were not high. However, it would not have been unfair for NATS to pay high levels of compensation to airlines in that year. The service provided was poor, resulting in significant passenger inconvenience and very high disruption costs to airlines. The service provided was not the inevitable result of implementing NERC. NATS' management attention was distracted from operational performance by its financial crisis, which exacerbated by the challenge of implementing the long overdue NERC and there was also significant staff unrest because of this and because of the unpopularity of the PPP. If a stronger delay term had been in place, NATS would have had much

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<sup>2</sup> On the assumption that the average flight will fly through more than one but less than two of NATS' sectors if it enters UK airspace.

stronger incentives to prevent the performance problems that did occur. This seems to be the main point of having such a term.

- 5.17 Clearly, it is theoretically possible that NATS' performance could be affected in a major way by "a dramatic shift in user operating patterns" or unspecified "changes in behaviour by other ANSPs", causing a deterioration in performance that NATS could do little or nothing to prevent. In such unlikely extreme scenarios, it is unclear why airline users should be expected to bear all such costs while NATS is spared from market forces. It is clearly much more likely that any poor performance beyond the ceiling would be due either to poor management by NATS or to very high traffic levels. In either case, there is no case for the ceiling. Therefore this makes the CAA's proposal even more unbalanced in NATS' favour.
- 5.18 We are disappointed that the CAA acknowledges on the one hand that very high delays are most likely to result from high traffic levels, when NATS will be in receipt of significant additional revenues, or from NATS' management failures, when NATS should not expect to make the allowed level of profits, but not to change its proposals for a ceiling simply because of the small chance that such delays might result from other causes. If the CAA sets the price cap on the basis that all risks, however extreme, must either be funded through the cost of capital or protection given to NATS, the proposals will clearly be unbalanced. The CAA should in our view take account of the theoretical possibility of reopening the price cap in such extremes (which is precisely why NATS has been given this right). The CAA should also take account of the fact that NATS has a statutory duty under Article 8 of the Transport Act to take all reasonable steps to secure that the system is efficient and coordinated; that demand is met and to have regard to the demands which are likely to be placed on them in future. Therefore users should be entitled to expect NATS to plan ahead effectively, taking account of the fact that demand is unpredictable and will be influenced by events outside its own control.

We can support a ceiling only if the service standard is set at 30 seconds.

### **Structure of the Incentive**

- 5.19 The case for symmetry can be made only if the par value is set at a level that is equally fair to users and to NATS, which the CAA proposals are not (for the reasons discussed above). If, despite our arguments, the delay term is to be loosened in NATS' favour, as proposed, the standard becomes, conceptually, not a true performance standard, but a *maximum* level of delay performance. In that case, the term would have to be made asymmetric, with no financial benefit to NATS from performance better than 45 seconds.
- 5.20 Alternatively, we could support the case for symmetry if the standard were set at 30 seconds, which is the level we are paying for. It would be fair to reward NATS for improvements above and beyond this agreed level.

- 5.21 We do not accept that, looking at the year as a whole, the benefits of better than expected performance are the same as the costs of worse than expected performance. Airlines must build in contingencies to allow for delays. Since many of these costs are sunk whether or not the delays materialise, the full benefit of delay reduction will not materialise in practice (until there is evidence of a sustained performance improvement).
- 5.22 We strongly support the proposal to add weightings for long delays and for delays to aircraft arriving/departing between 0500-0900 local time.
- 5.23 However, it is difficult to understand how the proposal would work in practice because no examples are given and the mathematics and wording of the CAA's proposal is hard to follow. In particular, it is unclear:
- Whether the 1.33 weighting applies every year or would be adjusted;
  - How the weighting would apply to performance bonuses, since the document only discusses penalties;
  - Which flight time measure is used to compare with the time of day weighting? Is this based on flight plan arrival/departure time or time of entry into UK airspace or some other measure?
- 5.24 We are also concerned that the par value of 45 seconds somehow seems to have been converted into one minute in Table 6.1 because of the weighting calculation. This is both confusing and unhelpful. We seem to have come back to a one minute performance standard. Although this is clarified partially in 6.49, 6.49 does not explain the weighting calculations.
- 5.25 We agree with the CAA that short flights should not be weighted more heavily than long flights. The cost of delay was found by the University of Westminster report to be greater for long flights which carry many more people.

## 6.0 Operating Expenditure

- 6.1 As indicated in our response to the CAA initial proposals operating expenditure accounts for approximately 70% of NERL's revenue requirements. Therefore, it is essential that the final regulatory settlement contains policies and incentive properties that are appropriate for NATS, given its history and position in the market.
- 6.2 Given NATS' capacity to find savings, the added incentive of the rollover mechanism and the potential for efficiency improvements described by the consultants retained by the CAA to review NATS opex it is reasonable to expect NATS to achieve further significant opex savings in CP2. In our view the opex efficiency targets of the CAA's initial proposals were achievable without presenting operational or service quality risks. As a world class ANS provider NATS should be expected to keep up with industry best practice in terms of year on year efficiency gains.
- 6.3 In our response to the CAA's initial proposals we indicated that the CAA rightly recognised that salary levels for central corporate functions tended to be higher than the median and stated that this should unwind during CP2. For Finance, IT and facilities, the KPMG paper clearly substantiated the fact that salaries are higher than average and clarifies that Swanwick relocation is a major factor in this situation arising. We were concerned that this situation may not unwind in CP2 due to a couple of factors highlighted in the KPMG report. These are planned above inflation wage rises on existing salary levels and no firm plans by NATS as to how to tackle higher than average salary levels over the control period. Deferring the operating efficiency target increase from 2% to 3% by a year further increases our concerns in this area.
- 6.4 Since the CAA has published the firm proposals Eurocontrol has circulated 2006 unit rate forecasts. Despite the regulatory regime, these show that NATS are now forecast to have the highest en-route unit rate in the Eurocontrol system for 2006, (moving up from second highest) more expensive than ANSPs operating on a full cost recovery mechanism who do not necessarily exhibit best in class characteristics.
- 6.5 Finally the current financial performance of NATS should inform the CAA's assessment of the company's capacity to outperform forecasts. NATS has just declared record profits for 04/05 with the NERL monopoly providing the greatest contribution to these with a NERL operating profit margin of 21% for the year 2004/05 (operating profit of £ 114.8m against revenues of £ 542.3m). This is a huge contrast to NATS previous performances and is indicative of its future likely attainments. NATS ability to outperform targets indicates there is merit in closely monitoring its performance in this area.

## 7.0 Capital Expenditure

- 7.1 We continue to support the 100% allowance of NATS' Capex plan provided there are some safeguards in place to ensure on time and to specification delivery of capital projects.
- 7.2 However, the CAA's preferred option still leaves the user community more exposed to the risk of under delivery by NATS than the incentivised framework suggested by BA or the alternative proposal around the CMM index offered by NATS. The requirement to have NATS deliver the plan by a fixed date and achieve an independently verified defined level of project management CMM capability, are a positive step to influencing behaviour that will increase the likelihood of good project management. However the recourse available to users in the event of these criteria not being met is weak. The CAA should recognise the limitations of the SIP process in that users are simply consulted and have no right of rejection of the SIP. Furthermore, whilst failures linked to under spend of CAPEX during CP2 will be addressed through the RAB for CP3, failure resulting in an overspend to get to a particular point in the project lifecycle is not addressed in CP3. Such an outcome could be indicative of inefficient investment during the project.
- 7.3 In its discussion of the various approaches to capex incentives the CAA rejects linking incentives to the delivery of the Caspian milestone plan (Option 2) on the grounds that NATS may simply deliver a plan to meet the deadline which has easily achievable deliverables within it. It is worth noting that the CAA's preferred approach does not address this issue either. Option 2 could be enhanced now by using independent consultants to specify criteria for what would constitute a quality project plan at the outset and which is subject to independent scrutiny on the level of delivery achieved.
- 7.4 A reason the CAA cites for rejecting Option 3 is that whilst NATS may achieve a defined level of project management capability, their joint partners may not. In the commercial world many projects rely on the outputs of suppliers or other third parties. Managing these to deliver to plan as agreed is part of any contract and part of the project management governance exercised by the main contractor. The issue of independence of measurement is raised as a barrier to accepting this option, but this would appear to be surmountable because the CAA has stated this as a feature of its preferred option.
- 7.5 We believe that the CAA preferred option, together with the award of 100% of Capex funds leaves the user community exposed in the event of non-delivery of Caspian during CP2. At the oral hearing NATS indicated acceptance of their accountability to users and were prepared to "stand up and be counted" on investment delivery. We consider that an approach that stipulates delivery of a Caspian plan (with a pre-defined framework for outputs), together with independently verified achievement of a specified capability level would be a fair and definable approach which could be linked to financial incentives. Fulfilment of the above criteria would mean NATS having a credible plan that they then have a strong likelihood of subsequently delivering and reflect the accountability NATS realises it should accept.

## 8.0 Cost of Capital

- 8.1 In response to the CAA's initial proposals, which set the cost of capital for the NATS price control review at 6.5%, BA expressed the view that the appropriate cost of capital for NATS should be considerably lower, in the range 5-5.5%. We stand by the proposals on the individual components of the Capital Asset Pricing Model, as set out in our previous submission, and we do not repeat our comments here.
- 8.2 In its firm proposals, the CAA has raised its proposed cost of capital further to 6.75%, to accommodate a number of minor technical issues. The CAA therefore appears to have rejected our arguments, although it provides little detail to support its decisions. The CAA merely asserts that it disagrees with many of the comments submitted to it.
- 8.3 The CAA's overall approach is to justify a high cost of capital assumption as part of what appears to be a cautious approach to the price review. The CAA believes that this is warranted by NATS' financial position, and that a cautious approach is in the best interests of users. Thus "the CAA considers it is in users' best interests that it exercises a degree of caution when interpreting the estimates and assumptions" (Para 9.28).
- 8.4 However we reiterate our view that the CAA is too cautious in treating NATS' financial position as unduly precarious. It is the role of a regulator to balance the interests of users with the need to avoid imposing an unfair financial burden on NATS. We agree that it is in the interests of users that NATS should be in a robust financial condition. But we believe that the CAA has not satisfactorily balanced these considerations, erring throughout the price review on the side of generosity towards NATS in several instances, eg. the failure to introduce satisfactory capex triggers and diluting the service quality metrics from those put forward in the CAA's initial proposals.
- 8.5 By itself, the CAA's cautious approach on other aspects of the review should justify a reduction in the cost of capital facing NATS. Instead, the CAA pays scant regard for the reduction in risk facing NATS as a result of the Composite Solution. By taking the opportunity to round up the figures at every stage of the process, the CAA risks introducing a significant element of upward bias into the proposed cost of capital. For instance, the CAA has adopted a figure close to the top end of the estimated range of 5.9% to 6.9%. The resulting price cap affords considerable protection to NATS' finances, while not adequately protecting the interests of users.
- 8.6 The proposed reduction in the cost of capital from 7.75% to 6.75% since CP1 – a decline of just one percentage point – is entirely accounted for by the lower risk-free rate. This reflects the decline in UK real long term interest rates that followed the transfer of control over interest rates to an independent Bank of England in 1997. There has therefore been no reduction at all in the proposed cost of capital since CP1 based on the specific circumstances of NATS. Indeed, on this basis NATS is being given the opportunity to earn a

slightly higher cost of capital than in CP1. The CAA has not provided a solid justification for this decision.

- 8.7 By common consent the risk facing NATS has been significantly reduced by elements of the Composite Solution, such as the volume risk-sharing arrangements. As the CAA itself acknowledges, “The CAA agrees, however, that investors in NERL bear less risk than in earlier years” (Para 9.7). This clearly suggests that the CAA’s proposed cost of capital is too high.