

NATS Price Control Review 2006-2010
CAA's Firm Proposals dated May 2005
Response by bmi – July 2005

bmi has reviewed CAA's firm proposals for NATS price control for the five years commencing in 2006. Having participated throughout the consultation process, our comments at this stage are limited to key issues, but should be considered in conjunction with the detailed responses we have made to date during this process, as follows;

- bmi response to CAA's initial consultation, dated June 2004
- bmi response to CAA's initial proposals, dated February 2005
- bmi hearing held March 2005
- bmi letter re service quality and capex triggers, dated May 2005

Key issues

1 Capital investments

We strongly believe that capital investments should be remunerated according to delivery.

We accept that NATS are in part incentivised to deliver the investment programme as planned and documented in SIP 2005, and we fully appreciate that plans may need to change during CP2 for various reasons. We note that the CAA intend to review NATS project management capability at September 2006, and undertake reviews of NATS supply chain management and project post implementation reviews.

However, these measures of incentivisation and management capability are quite separate from the concept of remuneration related to delivery, or 'pay for what you get'. Should investment delivery fall behind schedule or not take place for whatever reason, including reasons beyond NATS' control, there should be some pricing adjustment during CP2. Various proposals were explored by the working group and we still believe that a simple financial trigger - linked to the components of price -

could be implemented according to whether major key outputs have been delivered. eg) the depreciation allowance could be held in full or pro-rated for key outputs not delivered in the previous year according to the date shown in SIP 2005.

Investments for consideration could include, but are not limited to;

- completion of new Scottish Centre by September 2006

- completion of specified radar replacements by September 2006

- implementation of automation tools by April 2008

Unless financial targets are built into the price control framework, users pay throughout CP2 regardless of the investment programme actually delivered, and any retrospective adjustment is then made over the following 5 years. Whilst financial triggers are still some way from normal commercial dealings, as highlighted through the working group, we believe they represent a reasonable approach which could and should be built into the price control.

2 Service quality

We are disappointed that the par value has been revised from the previously proposed 32 to 45 seconds, rather than in line with performance levels achieved in 2004 (average 25 seconds), or further improvements as seen to date in 2005. Much work has been undertaken to reduce NATS attributable delays to current levels, and it appears somewhat perverse to set a par considerably above current performance, especially when the price control for CP2 allows for full remuneration of the investment programme and operating expenditure per 'high case' traffic, and when the price cap assumes base case traffic.

We continue to believe that service quality rebates should be directed to those users affected by delays, and that a simple average performance measure by airline could be adopted, which is measured and calculated by NATS, and invoiced and collected via Eurocontrol, accepting that a small system change may be necessary by Eurocontrol to accommodate this process. However, various current SES proposals may necessitate Eurocontrol system changes within the next year, in any event, which may provide an opportunity to introduce billing of a NATS airline specific performance measure.

3 Cost of capital

We accept that any omissions or errors in determining the cost of capital should be corrected, and we note that a range of 5.9% to 6.9% resulted from the CAA's latest review. The previous proposal of 6.5% seemed overly generous yet it would appear to be consistent with the revised range determined by the CAA. We are disappointed therefore that the CAA has decided to exercise further caution and increase the rate from the initial proposal of 6.5% to 6.75%, especially given that a price profiling adjustment has now been included in the price cap, advancing £30m of depreciation from CP3, thus improving NATS' position to secure finance. We maintain that the cost of capital should probably be around 6%.

Summary

We consider that the regulator has been careful to ensure that the price control for CP2 will enable NATS to operate on a financially robust and sustainable basis, and allow NATS to earn a reasonable return, and we note the price profiling adjustment and other risk mitigating measures which have been incorporated into these proposals accordingly. However, we believe that the cost of capital is overly generous and should be closer to 6%.

In addition, we consider that further adjustments should be made, which would not seriously jeopardise the position reached, namely that financial triggers should be established against delivery of the investment programme, and that the delay term par should be brought more into line with current levels of performance.

Measuring average delays by airline would also be more reasonable, with direct recompense where performance falls below par, and this would not affect NATS financial performance in any way.