

## **IATA response to the CAA's Firm Proposals of May 2005 on the NATS Price Control Review 2006-1010**

### **Summary**

#### **NATS NERL Price Control**

- We want to see a financially and operationally robust NATS, but at a better price with improved cost-efficiency.
- The CAA's Firm Proposals have weakened the annual average reduction of the EUROCONTROL and London Approach price control from the initial 4.8% per annum to 3.8%.
- Against the background of the extensive risk-mitigations that has been given and considered for NATS we do not believe that the proposals are sufficiently balanced, proportionate or challenging for a privatized and independently economically regulated ANSP.
- We believe that the original Initial Proposals for an average annual reduction of 4.8% per annum in the p/km allowance are more appropriate for NERL.

#### **Oceanic Price Control**

- We believe the underlying operational cost efficiency rate should be nearer the initial proposal of 2.5%.
- We therefore believe the Oceanic price control should be more challenging than the straight 4% per annum proposed.

### **1 Introduction**

We welcome the opportunity to respond to the CAA's Firm Proposals for the NATS price caps 2006-10. Our participation in this important consultation process has already been made in detail through:

- IATA response of 12 June 2004 to the CAA's Initial Consultation Document March 2004.
- IATA response of 28 February 2005 to the CAA's Initial Proposals of November 2004.
- IATA's Oral Hearing of 18 March 2005 with the CAA Review Panel.
- IATA's proposals to the Capital Expenditure "Triggers" Working Group, April-June 2005.

This submission on the CAA's Firm Proposals is therefore mainly in response to significant changes since the Initial Proposals.

## **2 Our views on changes since the Initial proposals**

2.1 We note the CAA has significantly softened its proposals from the 'initial' implied average annual reduction in the pence p/km allowance of 4.8% each year that we fully supported, to 3.4% in the 'firm' proposals.

2.2 The CAA point out the proposed 3.4% is still 'somewhat above' the 3% average annual reductions in unit costs for European providers of air traffic services set by EUROCONTROL's (ECTL) Performance Review Commission (PRC).

2.3 We do not believe that a small difference of 0.4% can be considered 'somewhat above', and more importantly we do not believe it is appropriate for NATS to be compared with all the other European ANSPs who are Government owned under the "full cost-recovery" system, which is generally accepted as not having any incentive to control costs or improve cost-efficiency.

2.4 It should also be noted that the PRC is only an advisory body. Our understanding is the 3% target has not been agreed by the ECTL Provisional Council decision-making body (including UK). More significantly it should be noted however that the average weighted unit rate reduction in Europe for 2005 year has been -7.3% and -2.4% for 2004 compared to the UK's -1.7% and -0.6% respectively (in Euro terms in which we are charged and pay our bills).

2.5 In 2006 based on the CAA's 'firm proposals', the UK will be the highest of the 32 ECTL unit rate charges (it is currently ranked 4<sup>th</sup>). We would query why Europe's only privatized and independently economically regulated ANSP should be in this position. UK will be 4.3% ahead of the 2<sup>nd</sup> unit rate and 30% above the average in Europe. In terms of cost per km the UK is also the worst performer in Europe.

2.6 We recognize that NATS has relatively dense and complex airspace, particularly in the London TMA. However, this density also significantly increases revenue opportunity and better enables economies of scale, utilization of assets and improved productivity.

2.7 NATS has been given a substantial raft of additional risk-reduction measures since the 'initial' proposals:

- Cost of capital increased from 6.5% to 6.75%.
- Un-remunerated operational expenditure has been reduced from GBP 50 to GBP 35.
- Operating expenditure efficiency target reduced from 3% to 2% for 2006.
- Capital expenditure allowance increased from 80% to full 100%.
- Allowance of GBP 30m depreciation will be advanced from the next Control Period (CP3).

- Service quality delay par target relaxed from 32 seconds to 45 seconds per flight.
- Maximum delay penalty reduced from GBP 27m to 24m per annum.

2.8 These risk-reductions measures are in addition to those introduced at the Initial Proposal stage:

- Elimination of aircraft weight risk.
- Full cost pass-through for pension costs and any potential radio-frequency spectrum use.

2.9 It must also be considered that NATS had already been given some significant risk-reduction measures as part of the "Composite Solution". As well as price increases for 2003-05, these included:

- Introduction of the 50/50 traffic volume share risk.
- A 12% increase of the Regulated Asset Base from the beginning of Control Period 2 (2006-10)

2.10 With regard to risk reduction measures, while we believe that the 50/50 volume share risk was originally agreed during the "Composite Solution" on the basis it was "an exceptional user contribution", we note it now appears to have become a permanent feature.

2.11 In comparison to this substantial menu of existing and proposed risk or mitigation measures, NATS airline customers are doing business in an increasingly competitive business where all the risks have to be faced.

2.12 We recognize that NATS has made considerable progress since PPP and the "Composite Solution". Following the successful Bond Issue and gearing reduction, NATS is now financially and operationally much stronger. The Group has just reported its first significant pre-tax profit of GBP 69m and declared dividends for shareholders. We note NATS credit rating was upgraded to Baa1 by Moody's in June 2005.

### **3 Operating costs**

3.1 We welcome the CAA's proposals on operating cost reductions for CP2. Given that some 70% of NATS costs are staff-related we believe this will incentivise NATS to ensure working practices and pay agreements deliver improvements in flexibility and improved productivity. As airline customers operating in an open intensely competitive market we also have to robustly address these issues, and we expect the same of our suppliers.

### **4 Capital Expenditure**

4.1 We accept that much of NATS investment is incentivised through the CAA's operating cost and service delivery incentives. Nevertheless we are disappointed the CAA has not agreed our proposal to introduce capital expenditure "triggers" to incentivise effective delivery of the investment

program. Our requirement is to ensure that these are linked to delivery and that “we only pay for what we get”.

4.2 Our requirement is also driven by NATS poor record of procurement and project management for which we are still paying the cost. We note the CAA proposes to assess the CASPIAN program against Capability Maturity Model principles, and for NATS to re-plan the program in consultation with the users if pre-determined levels are not achieved. While this is a step in the right direction our concerns are that firstly CASPIAN only represents some 30% of the investment, and secondly that the assessment and any re-planning does not mitigate the risks of inefficient or ineffective spend if we are paying for it through pre set charges over the control period.

4.3 We believe that it is appropriate for simple financial triggers to be applied to key outputs such as:

- Completion of the New Scottish Centre by September 2006
- Completion of specified radar replacements by September 2006
- Implementation of automation tolls by April 2008

## **5 Cost of capital**

5.1 In our detailed response to the Initial Proposals, and at the Oral hearing, we gave our reasons that the cost of capital should be closer to 6.1% for a financially robust monopoly provider with a generally assured source of revenue. Taken together with the comprehensive list of existing and new risk-reduction measures for NATS, the proposed increased rate of 6.75% appears excessively generous.

## **6 Service Quality**

6.1 Delay performance is clearly the most important service quality issue for airlines. We are therefore disappointed that the CAA has proposed to soften the delay penalty from a maximum GBP 27m per annum in the initial proposals to GBP 24m in the firm proposals. Similarly the effective delay par has been significantly reduced from 45 seconds to 32 seconds.

6.2 We accept that NATS should not be penalized for any delays outside its control. However, the proposals are out of line with the good delay performance that has been achieved over the last two years. It seems somewhat perverse if the par is being set considerably above current performance when the price control allows for full remuneration of the investment program, and with the operating expenditure based on the ‘high case’ while the price cap assumes ‘base case’ traffic.

6.3 The current and proposed delay terms are extremely modest in relation to the real cost of delays to the airlines. While the delay performance incentive is clearly not intended to compensate for these

significant costs, NATS must be given a robust financial incentive that focuses attention on their customers' major service quality requirement.

## **7 Our views on the Firm proposals for NERL**

7.1 As a key supplier of an essential service that has a significant impact on our operations and service quality, we want to see a strong and successful NATS. This must however be delivered at a better price and cost-efficiency. We welcome the new commercial approach and strong leadership by NATS. As a key but monopoly supplier in our industry value chain this must however be better balanced by the Regulator.

7.2 In view the monopolistic nature of ANSP provision, we believe the Regulator's prime Statutory Objective is to protect the interests of the users. Regulation is after all a proxy for competition. We also note that the first principle of "Better Regulation" is to ensure that regulation is proportionate by ensuring that the proposals take proper account of the particular circumstances of NERL and its customers.

7.3 Against the background of the extensive risk-mitigations that have been given and considered for NATS, and the reasons above, we do not therefore believe that the proposals are sufficiently balanced, proportionate or challenging for a privatized and economically regulated ANSP. We believe that the Initial Proposals equivalent to an average annual reduction of 4.8% per annum in the p/km allowance is more appropriate for NERL.

## **8 Oceanic Price Control**

8.1 NATS charges are significantly higher than the comparable service provided by Nav Canada.

8.2 The proposed operational expenditure efficiency rate of 2.5% at the 'initial' proposals has been reduced to 2%. As proven by its out-performance of the forecasts used to set prices in CP1, NATS has the ability to find significant savings within the current RPI-Z incentives. On this basis, and in view that operational expenditure represents some 90% of the allowed revenues, we believe the underlying efficiency rate should be greater than 2%.

8.3 Given that:

- NATS charges are significantly higher than the comparable service provided by Nav Canada.
- The CAA has proposed the same generous cost of capital rate as for NERL.

We therefore believe the Oceanic price control should be more challenging than the straight 4% per annum proposed.

Geneva 29 July 2005