



***AN AD HOC* REVIEW OF NATS RELATED RISKS**

FINAL REPORT

January 2013

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 licensed provider is an essential requirement of airspace users and is necessary for the CAA to meet its duties and obligations under EU and UK legislation.
- S2. In March 2012 the Board of the CAA established an ad hoc group of its members to review whether any changes were required in its regulation of the current licence holder, NATS (En Route) plc (NERL). The decision to establish the group followed the identification of a number of trends and future challenges, together with the Government's Better Regulation Principles which suggest that regulators should periodically review their frameworks in light of future challenges and risks to ensure they remain targeted and proportionate.
- S3. The CAA identified in its Interim Report, published in September 2012, a number of future airspace trends that may raise challenges for the regulation of NERL over the period leading up to 2020. These trends and challenges included:
- forecasts for long-term traffic and congestion, which may challenge traditional approaches to safety, airspace and air traffic management;
 - NATS through its subsidiary NATS (Services) Limited (NSL) aiming to develop significantly its business outside its en route monopoly, which may expose NERL to risks from this activity; and
 - the further development of the Single European Sky (SES) programme, which is expected to challenge NERL's performance expectations - especially its cost-efficiency.
- S4. This document sets out the CAA's conclusions following its careful evaluation of stakeholder responses to its Interim Report. This Final Report confirms:
- the **strategic outcomes** the CAA wishes to secure through its regulation of NERL over the next few years. These strategic outcomes should help guide stakeholders on the priorities that the CAA sees for its regulation and relationship with NERL over the period leading up to 2020; and
 - the future **CAA actions** that will be best designed to help pursue these outcomes.

- S5. Broadly speaking, many of the risks identified in the Interim Report can be mitigated, but not eliminated, through the CAA taking a different approach to its use of existing regulatory levers. For example, there are a number of areas where more proactive scrutiny by the CAA of NERL's business plans is desirable. This includes the CAA's oversight of NERL's long-term business plans from a safety delivery and assurance perspective and the CAA's oversight of NERL's financial resources. There are also actions where the details will be shaped by the CAA work programmes including its Future Airspace Strategy (FAS) and its work required under the second reference period of the EU Performance Scheme (2015-2019). Finally, there are a number of areas where further clarity or evolution in NERL's licence conditions will help provide the CAA and airspace users with greater assurance.
- S6. In the related areas of NERL's governance and financial ring-fencing, this Final Report does not reach firm conclusions but rather sets out the CAA's high-level objectives that will shape a separate review to be launched in 2013. Should this lead to proposals to modify NERL's Licence, the CAA would consult stakeholders in the usual way once the review is complete.
- S7. The CAA aims to take a risk-based approach to its regulation of NERL. The CAA has not reviewed every aspect of its regulation of, 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 January 2013

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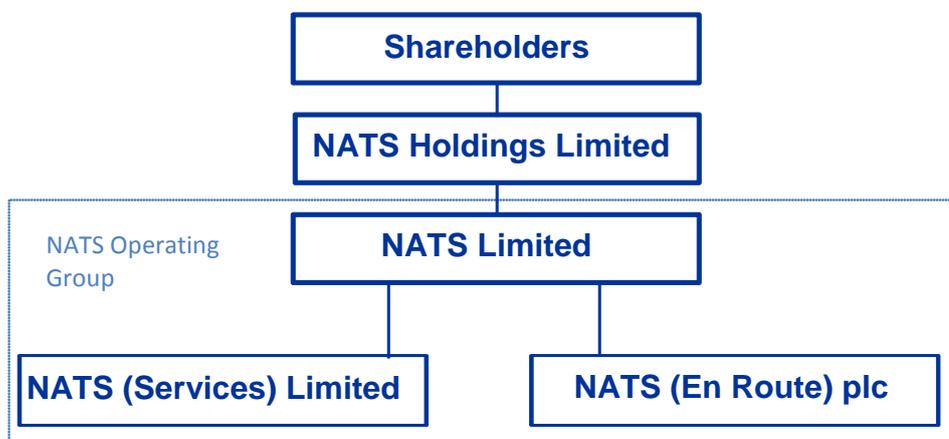
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1. Introduction

(a) Terms used in this document

- 1.1 References to NATS relate to NATS Holdings Limited (NATS Holdings), which is the ultimate parent company of the NATS group of companies, and its direct and indirect subsidiaries, associates and joint ventures. 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 an indirect subsidiary of NATS Holdings¹ 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. NATS Limited is a subsidiary of NATS Holdings Limited and the direct parent company of NERL and NSL. NATS Limited, NERL, and NSL and their subsidiaries are together referred to, in this report, as the 'NATS Operating Group'. The following figure sets out a simplified corporate structure of NATS.

Figure 1.1: Simplified corporate structure



- 1.2 Annex I contains a glossary of terms used in this document. Annex II sets out the CAA's duties under the Act. Annex III sets out the draft recommendations from the CAA's Interim Report, published in September 2012.

¹ NSL is a direct subsidiary of NATS Limited which also holds the shares in NERL. NATS Limited is a subsidiary of NATS Holdings.

(b) Purpose of the ad hoc review

- 1.3 As the UK's monopoly en route provider, NERL is critical to the provision of safe, efficient and sustainable air transport. 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 Some of the trends and future challenges that, taken together, led to the decision to undertake the ad hoc review included:
- the need to understand passengers' interests in the longer term in relation to a safe, efficient and sustainable air navigation system;
 - NSL's future business strategy;
 - the role and appetite of NERL in delivering the FAS;
 - the government's 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's criticisms of NERL's cost-efficiency contribution to the SES programme;
 - examples of differing expectations between the CAA and NERL in relation to certain aspects of the Specified Services which NERL is required by its licence to provide;
 - 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 The terms of reference for the *ad hoc* review were approved by the CAA Board in March 2012. The main focus of the review was the CAA's regulation of NERL, the en route regulated business. The review was interested in other activities of NATS to the extent that they either created 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 1.2: 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 group of CAA Board members chaired by David Gray (Non Executive Director). Members include: Andrew Haines (Chief Executive); Gretchen Haskins (Safety Regulation Group Director); Iain Osborne (Regulatory Policy Group Director); and Mark Swan (Director of Airspace Policy).
- 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. Members include: Richard Moriarty (Regulatory Policy Group); Kirsten Riesema (Safety Regulation Group); Phil Roberts (Airspace Policy Group); Dave Snowden (Safety Regulation Group); and David Stoplar (Legal Adviser).
- Interim Report to CAA Board in July 2012 and Final Report to CAA Board in December 2012.

Source: CAA

1.6 The review was structured into four broad phases.

- Phase I – the identification of future trends and challenges in the regulatory operating environment. This horizon-scanning process focused on the period leading up to 2020 (and in some cases beyond). This period 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.
- Phase III – a 'gap analysis' of potential future risks and current and possible regulatory levers to mitigate these risks.
- Phase IV – the development of recommendations for CAA action in line with the Better Regulation Principles.

(c) Consultation with stakeholders

1.7 The CAA published an Interim Report on the work of the *ad hoc* Board group in September 2012.² Views were invited from interested parties by 19 October 2012. Responses were received from NATS, the Unions representing NATS employees, Ryanair, Heathrow Airport Limited (HAL), and The Manchester Airport Group plc (MAG). These responses have been published on the CAA's website.³

² <http://www.caa.co.uk/docs/2492/NATSRisksReviewInterimReport.pdf>

³ <http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=14055>

- 1.8 The *ad hoc* Board group held two meetings with invited stakeholders. One meeting was held with NATS. The other was with airline user representatives and included representatives of easyJet, Ryanair and International Air Transport Association (IATA).⁴

(d) Conclusions and next steps

- 1.9 This Final Report concludes the work of the *ad hoc* Board group. It sets out the group's view on the strategic outcomes that should influence the CAA's regulation of NERL (and NATS) over the period leading up to 2020. It also sets out a number of recommendations for action that will shape the relevant work programmes in the CAA's Business Plan.
- 1.10 This document does not replicate the discussion on risks and regulatory levers that was set out in full in the Interim Report. Instead it seeks to assess representations by interested parties in response to the Interim Report and discuss whether changes are necessary in reaching the CAA's conclusions.
- 1.11 In two important inter-related areas – NERL governance and the financial ring-fence – the work of the *ad hoc* group has not resulted in firm conclusions for CAA action at this point. It has identified that certain risk mitigation measures are likely to be appropriate, but these will require further more detailed evaluation. This will be the subject of a specific new project launched by the CAA's Regulatory Policy Group in 2013.
- 1.12 If you would like to discuss any aspect of this report with the CAA please in the first instance contact Richard Moriarty at Richard.Moriarty@caa.co.uk. If you would like to discuss the work that will be taken forward on NERL governance and financial ring-fencing please contact Rob Cowle at Robert.Cowle@caa.co.uk.

⁴ British Airways was invited but was not able to attend.

2. Strategic outcomes for the CAA's consideration

(a) Interim Report

- 2.1 The Interim Report set out six draft strategic outcomes that should influence the CAA's regulation of NERL (and NATS) over the period leading up to 2020. Five of these outcomes related to long-term (or strategic) safety management; enhancing economic value for airspace users; NERL maintaining sufficient financial and other resources; NERL playing its full part in FAS; and NERL being clear on the nature of its obligations in its Licence and its relationships with the CAA.
- 2.2 The sixth outcome, which should result from the successful pursuit of the other outcomes, is that the CAA, in undertaking its regulatory functions, should be in a position to be neutral with respect to the ownership of NERL as it has sufficient regulatory levers to achieve its regulatory objectives regardless of ownership.
- 2.3 The intention of developing these strategic outcomes is to give greater coherence to the CAA's regulation of NERL (and NATS) across its various regulatory groups and to ensure that stakeholders have a clear view of the CAA's priorities in this area over the period leading up to 2020. They do not replace or diminish the CAA's statutory duties in making individual decisions.

(b) Representations

- 2.4 Broadly speaking there was a high degree of support from respondents for the CAA's approach and for the proposed strategic outcomes. There were, however, a number of general points that respondents had either on the draft strategic outcomes or the nature of the CAA's review.
- 2.5 NATS was keen for the CAA to ensure its review was risk-based and based on Better Regulation Principles. It argued that, before the CAA developed solutions, it should first evaluate the scale and significance of the risks it had identified and take into account the residual risk remaining after the mitigating actions that NATS had in place. Its view was that the CAA should only consider regulatory action if the residual risk was more likely than not to materialise.
- 2.6 The Unions representing NATS employees noted the regulatory responsibility of the CAA in relation to NERL, but questioned the distinction between NERL and NSL. From a customer and stakeholder point of view the Unions thought that there was little distinction between NSL and NERL because the travelling public were concerned with the gate-to-gate service in terms of safety, capacity and delay. The Unions took the view that NATS should focus on the core business, which it sees as both NERL's and NSL's ATM provision in the UK.
- 2.7 At the stakeholder session there was broad endorsed the draft recommendations in the Interim Report (and by extension the draft strategic outcomes), however, users

wanted much more focus on regulation driving NERL's charges down and ensuring its business was more cost efficient. The CAA received representations that it should take into account the incentives created by the current ownership structure of NATS, particularly with the Airline Group having a majority of the voting shares.

- 2.8 The CAA received representations at the stakeholder session that it should ensure its regulation and relationship with NERL was more focused on it contributing more positively to the SES goals. The CAA heard that airlines were disappointed with the way NERL had approached contributing towards the EU-wide cost efficiency targets for RP1 and urged the CAA to encourage NERL to make a more significant contribution for RP2.
- 2.9 HAL and MAG focused mainly on airport and terminal issues in their responses. In particular, HAL was keen on cost transparency of ANS and delivery of the benefits of the FAS and SESAR.

(c) Discussion

- 2.10 The CAA agrees with NATS that the Better Regulation Principles should guide its review especially in the formulation of mitigations to the risks it identifies. However, the CAA considers that NATS' view on how these principles should be applied sets an inappropriate standard for the regulator. It would imply that the regulator would not consider amending its framework despite significant risks being apparent: for example, only if it was more likely that not that NERL would run out of cash and become insolvent. As noted in paragraph 5.18 the CAA does not agree with this standard of test.
- 2.11 The CAA agrees with those that want to see greater focus on NERL's cost efficiency and direct charges in RP2. This is covered in more detail in Section 4.
- 2.12 The CAA agrees that its strategic outcomes should make a direct reference to SES given that the UK is fully committed to its vision and development. Regulation of ATM is increasingly being driven by changes at the European level.
- 2.13 The CAA notes the views about ownership structure. However, as explained in Section 8 the CAA is keen to ensure that it can achieve its regulatory outcomes regardless of the ownership structure, as this is something over which the CAA has no control. This is not to say that ownership incentives that result in risks to these outcomes should not be taken into account (for example price caps should be designed to avoid excessive returns in relation to profit seeking incentives).
- 2.14 The CAA welcomes the comments made by HAL and MAG in relation to terminal ANS. The CAA considers these validate its focus on the development of strategic capabilities (see Section 6) and ensuring that in its consideration of enhancing economic value (see Section 4), due regard is given to this being on a gate-to-gate basis rather than just focused on the *en route* part of the market.

(d) Conclusions of the *ad hoc* review

2.15 Figure 2.1 sets out the CAA’s conclusions for the strategic outcomes that should guide its regulation and relationship with NERL over the period leading up to 2020. It includes two changes from the draft strategic outcomes in the Interim Report to reflect more direct references to NERL’s contribution to the SES Performance Scheme and SESAR:

- Outcome ii ‘economic value’: now includes an explicit reference to the need for NERL to make a sufficient contribution to the SES Performance Scheme EU-wide targets⁵ in addition to enhancing value for airspace users by reducing the direct and indirect costs of *en route* service provision.
- Outcome iv ‘strategic capabilities’: now includes an explicit reference to SESAR.

Figure 2.1: Strategic outcomes for the CAA’s regulation of NERL

Outcomes to be pursued in the period leading up to 2020
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. NERL makes a sufficient contribution to meeting the EU-wide targets under the SES performance scheme in addition to increasing economic value for airspace users by reducing the direct 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 the FAS (as part of the UK’s deployment of SESAR), 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

(e) Uncertainty

2.16 There are many uncertainties that may shape the future. These include future traffic and congestion trends; SESAR and new technology deployment; developments of the SES performance scheme; the potential for ANSP international diversification, collaboration, and consolidation and potential future ownership change. These

⁵ The EU-wide targets apply to Member States, not directly to NERL. While NERL is the largest single element (approximately 85 per cent) of the UK rate, it is not the only contributor to determined costs, other contributors are Met Office, the Department for Transport and the CAA.

uncertainties reinforce the need for the CAA to keep its regulation of NERL under review and periodically review it to ensure it remains fit for purpose and in line with Better Regulation Principles.

Figure 2.2: Overarching conclusion and action to pursue the CAA’s strategic outcomes

Conclusion and action	
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. The CAA will periodically review its regulatory frameworks to ensure they remain fit for purpose and in line with Better Regulation Principles.

Source: CAA

3. Enhancing safety outcomes

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.

(a) Interim Report

- 3.1 The CAA set out two key draft recommendations in relation to this strategic outcome. The first related to the need for NERL to develop its strategic or long-term safety risk capacity, and for the CAA to provide more proactive oversight of NERL's approach. The second related to the need for the CAA to continue to work proactively with Competent Authorities⁶ to ensure that NERL's collaborations with other ANSPs and equipment suppliers contribute to improving UK safety and do not have negative effects on NERL.

(b) Representations

- 3.2 There was general support for the CAA's recommendations in relation to safety. The airspace users in the stakeholder session recognised that NERL's performance on safety was excellent. NATS pointed out that it has one of the best safety records in the world. This confidence was also reflected in the responses from the Unions representing NATS employees, the airlines and HAL.
- 3.3 NATS re-iterated that safety was its priority. NATS was keen for the CAA to refocus its existing safety regulatory resources on the longer term future strategic safety risks given the CAA's acknowledgement of NERL's safety performance and competence being among the best in the world. NATS believed strongly that this shift of focus could be achieved by reducing regulatory oversight and scrutiny on areas of safety which already reflect, and in many cases lead, best practice.
- 3.4 NATS also encouraged the CAA to take a stronger leadership role in delivering industry-wide programmes to ensure that long term safety risks are addressed in the most effective and cost efficient manner for the industry as a whole.
- 3.5 The Unions representing NATS employees expressed concern about losing safety synergies if greater separation was introduced between the activities of NERL and NSL.

⁶ Competent Authorities are authorities responsible for the regulation of ANSPs in member states.

(c) Discussion

- 3.6 The CAA considers that the representations in response to its Interim Report generally validated its draft recommendations related to safety. The CAA notes NATS' desire for the regulator to shift its resources away from some routine oversight activities to support oversight of strategic risks management. The CAA's Enhancing Safety Performance programme aims to ensure that its oversight activities and resources are targeted on the biggest risks and that, together with stakeholders, the CAA is focused on agreed safety outcomes to mitigate these risks. This will mean a reduced focus on areas where safety and compliance are clearly demonstrated, the impact of 'failure' on the system is minimal and the risk is lower. Any shift of resources will be done in an informed, risk based manner.
- 3.7 The CAA notes the point raised by the Unions about safety synergies between NERL and NSL. The CAA would consider any safety related risks if there were to be greater operational and financial separation between the two businesses.

(d) Conclusions of the *ad hoc* review

- 3.8 Figure 3.1 sets out the CAA's conclusions and the actions it intends to take, in addition to its on-going safety oversight of NERL, in pursuit of the strategic safety outcome. It makes only minor changes to the draft recommendations to confirm them as conclusions.
- 3.9 These actions will be taken forward in 2013 as part of the business plan for the CAA's Safety Regulation Group.

Figure 3.1: Conclusions and actions to pursue the CAA's strategic outcome on safety

Conclusions and actions	
2.	The CAA will 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. The CAA will subject NERL's plans to increased regulatory oversight and scrutiny. The CAA will also subject 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.	With NERL increasingly collaborating with international partners and NSL seeking to expand its business in the UK and abroad, the CAA will 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.

Source: CAA

4. SES performance and economic value for airspace users

Strategic outcome:

NERL makes a sufficient contribution to meeting the EU-wide targets under the SES performance scheme in addition to increasing economic value for airspace users by reducing the direct and indirect costs of *en route* service provision.

(a) Interim Report

- 4.1 The CAA set out two draft recommendations in respect of enhancing economic value for airspace users. The first related to ensuring that its price control for NERL in RP2 made a sufficient contribution to the achievement of the European Commission's EU-wide targets, including on cost-efficiency. The second related to the CAA working with industry, its Functional Airspace Block (FAB) partners, and the Performance Review Body (PRB), to explore and promote more intelligent ways of measuring the inter-dependencies among the various key performance areas.

(b) Representations

- 4.2 Airspace users said they wanted to see more focus from NERL on cost efficiency in order to reduce direct charges for RP2 and make a more positive contribution to the achievement of the European Commission's EU-wide targets in the SES Performance Scheme. Airline users were keen for the CAA's regulation to focus more rigorously on ensuring NERL achieves further efficiencies. An airline was particularly keen for the CAA to review its approach to setting NERL's regulatory cost of capital for RP2. As discussed in Section 2, a stakeholder was keen to ensure that the CAA made direct reference to the SES programme in the articulation of its strategic outcome for enhancing economic value for airspace users.
- 4.3 NATS said it was keen to pursue how it could enhance total economic value for airspace users by reducing indirect costs in addition to reducing direct costs.

(c) Discussion

- 4.4 The CAA agrees with airspace users that it should focus on improving NERL's cost efficiency in RP2 and its contribution to the EU-wide targets under the SES Performance Scheme. The RP2 process is at a relatively early stage. The CAA, alongside DfT, is working closely with the European Commission and the PRB to review the legislative framework that will govern RP2.

- 4.5 Following confirmation of the legislative framework early in 2013, the CAA expects the European Commission will propose its EU-wide targets in June 2013. In advance of this the CAA has set NERL a number of business planning scenarios for unit rate reductions. The objective for the CAA is to ensure that NERL is subject to challenging cost-efficiency targets, which are realistically achievable and make a sufficient contribution to the EU-wide targets. The CAA, as part of its preparations for setting the NERL price control, will review the appropriate cost of capital that should apply for RP2 in addition to examining the other components of the price cap such as the capital programme, operating costs and depreciation charges.
- 4.6 In assessing the appropriate targets for NERL's cost efficiency, the CAA will need to ensure that airspace users' preferences in relation to capacity (delay) are taken into account. The CAA will also need to ensure that its approach to cost efficiency is fully co-ordinated with its objective to ensure NERL develops the requisite strategic capabilities for SESAR deployment and FAS. Finally, the CAA, alongside the IAA, will need to ensure there is a safety assessment of the UK-Ireland FAB plan for RP2.
- 4.7 The CAA agrees with NATS that NERL should continue to contribute positively towards reducing airline costs indirectly in addition to lowering its direct charges. For example, NERL's capacity has a direct bearing on delays, which creates costs for airlines through additional fuel and labour costs. NERL can also help contribute towards reducing airline fuel burn by developing more flight efficient routes that take into account both horizontal and vertical trajectories. The CAA considers its views on these issues will support the PRB in achieving its strategy, which the CAA understands from discussions with the PRB Chairman to be:
- to reduce indirect costs by targeting delay and flight efficiency;
 - to hold the cost base of front line activity constant, but increase efficiency through use of technology;
 - to maintain investment to provide adequate resources to enable change; and
 - to reducing support costs by restructuring and applying technology and shared service provisions.
- 4.8 The CAA does not support adopting a key performance metric for total economic value in RP2, not least because this has not been supported by the European Commission in the revised legislation governing the performance scheme. However, the CAA does support further research and analysis of the inter-dependencies between key performance areas to better understand their trade-offs. The CAA therefore proposes to engage fully with the forthcoming study by the European Commission on inter-dependencies between the key performance areas.

(d) Conclusions of the *ad hoc* review

4.9 Figure 4.1 sets out the CAA's conclusions and the actions it intends to take in pursuit of its strategic outcome of enhancing economic value for airspace users. It makes two minor changes to the draft recommendations:

- Conclusion 4 now includes a clear expectation that the targets the CAA expects to set NERL for RP2 will be challenging but realistic. It also now clarifies that the CAA will review the appropriate cost of capital for NERL for RP2.
- Conclusion 5 now includes a reference to working with stakeholders in the context of the forthcoming study by the European Commission on inter-dependencies among the key performance areas to make it clear the CAA wishes to work constructively with the European Commission in this area.

4.10 Actions number 3 and 4 will be taken forward as part of the business plan for the CAA's Regulatory Policy Group. In doing so it will work very closely with the CAA's Directorate of Airspace Policy and Safety Regulation Group. The CAA's decisions on the NERL price control and its contribution to the UK-Ireland FAB plan will be discussed and agreed by the CAA Board towards the end of 2013 or early 2014 following consultation with stakeholders. The CAA expects to publish an update for its process to review the NERL price control in February 2013 once the legislative framework for RP2 is settled.

Figure 4.1: Conclusions and actions to pursue the CAA's strategic outcome on economic value

Conclusions and actions	
4.	The CAA will seek 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. The CAA expects this to result in challenging, but achievable targets for NERL. NERL must prepare to respond positively to 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. The CAA will review NERL's costs, including an appropriate cost of capital, as part of its preparations for RP2.
5.	With airspace users expecting NERL to reduce the indirect costs it imposes on them as well as its direct charges, the CAA will work with stakeholders - in the context of the forthcoming study by the European Commission - to explore and promote more intelligent ways of measuring the inter-dependencies between various key performance areas.

Source: CAA

5. Sufficient resources for regulated activities

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) Interim Report

- 5.1 The CAA set out three draft recommendations relating to the governance of NERL and the financial ring-fence provisions in NERL's licence. In considering these issues the report noted that "consents"⁷ which the CAA had granted in relation to the ring-fence provisions could have the effect of weakening the protections provided by the ring-fence. The first draft recommendation related to exploring whether there was merit in reviewing the present NATS staffing structure, in which NERL's staff are all employed by its immediate parent company, NATS Limited, given that it was the existence of these arrangements that originally gave rise to the requirement for the consents. The second draft recommendation related to whether there were options to strengthen the ring-fence and regulatory oversight whilst the existing consents remain in place. The third draft recommendation related to whether there was merit in a licence modification to strengthen the assurance the CAA can derive that NERL directors will, in the event of any conflict between the obligations of NERL and the objectives of NSL or other NATS business interests, give priority to NERL's obligations.

(b) Representations

- 5.2 This was an area that attracted significant attention in the responses especially from NATS and the Unions representing NATS employees.
- 5.3 NATS agreed with the general thrust of the draft strategic outcome and noted that it closely reflected the on-going obligations of NERL and its Board of directors pursuant to NERL's licence. However, NATS thought that the definition and objective analysis of the concept of 'unacceptable' risk was key to whether the outcome is appropriate in the context of targeted and proportionate regulation.
- 5.4 NATS argued that the risk that the CAA should be concerned with is net (or residual) risk – i.e. the residual risk remaining after credible mitigations taken by the company. It noted that its Executive and Board had introduced a number of risk mitigation measures, and gave the example of the controls in place around a new

⁷ These consents effectively grant NERL derogations from the application of the ring-fencing provisions in the Licence. See <http://www.caa.co.uk/docs/5/20120713LicenceConsents.pdf>

- ATC tower contracts.⁸ Furthermore, NATS thought that the definition of 'unacceptable' risk should be where, whether on an individual basis or a portfolio approach, there is sufficiently reliable evidence that the accumulation of net risks are more likely than not to cause a shortfall in NERL's financial and non-financial resources that would result in a material breach of its licence obligation.
- 5.5 NATS set out two further tests which it thought should be met before mitigating action was required: a 'minimum remedial action' test and a cost benefit analysis from the perspective of all stakeholders.
- 5.6 In respect of the staffing arrangements, NATS noted that these had been in place since the PPP in 2001 and were 'intrinsic to the structure and philosophy of the PPP', which was 'designed by the DfT and accepted by the CAA'.
- 5.7 In the event that the CAA demonstrates that further action is required, then NATS encouraged the CAA to consider voluntary undertakings to provide the CAA with certain information to enable more informed on-going risk assessments to be made.
- 5.8 NATS said that while the CAA had correctly identified that the current financial ring-fence relating to NERL falls short of a perfect ring-fence model, it is a logical and necessary result of the corporate structure and operating concept of the PPP model. NATS said it would be disproportionate for the CAA to further strengthen the ex-ante safeguards to such an extent as to render redundant the safeguard of the Air Traffic Administration regime. Before any changes were to be considered, NERL told the CAA it would expect a full regulatory impact assessment to be carried out by the CAA, in full consultation with potentially affected stakeholders, to ensure that any proposed strengthening of the ring-fence was proportionate to the anticipated cost, complexity, management resources and associated risk to NERL that would likely result.
- 5.9 In respect of strengthening the governance arrangements of NERL, NATS noted that the Strategic Partnership Agreement requires NATS to apply the UK Corporate Governance Code to the extent practicable given the shareholder constitution. NATS noted that to change the structure of the Board of Directors of NERL in any meaningful way would require overriding powers for any proposed independent directors. Such a change would require a review and revision of the current shareholders' agreement with potential implications for existing commercial arrangements and would, therefore, raise the possibility of compensation for any affected shareholders. NATS noted that because there are existing independent directors on the NATS Holding board, any additional governance could be incorporated within the existing non-executive roles.

⁸in the analysis of the risk to NERL associated with the delivery of a new ATC tower contract by one of the NATS group subsidiaries, NATS noted that the risk mitigations it took included, but were not limited to: creating new subsidiaries so that the veil of incorporation protects the UK trading entity, strengthening its commercial capability, proactive management/governance of the bid regime leading to any resulting contract (appropriate selection criteria regarding markets, products and services and risk profiles and active rejection of opportunities that fail to meet such pre-specified risk criteria); contractual limitations of liability; time limited obligations; risk sharing with other stakeholders; insurance; and the operation of active contract and risk management.

- 5.10 The Unions representing NATS employees considered that the principal financial risk to NERL was not NATS' activities outside the regulated business but an overly stringent regulatory price settlement.
- 5.11 The Unions were concerned with the proposal that the CAA undertakes a detailed assessment of whether it is desirable or possible to change the staffing model, citing what it thought were many of the advantages of the current arrangements. The Unions broadly agreed with the idea of greater scrutiny and monitoring by the CAA as long as it was not unduly burdensome and allowed NATS to react to events and obligations.
- 5.12 HAL and MAG responses noted the importance of terminal ANS and supported the CAA undertaking a review of the staffing structure. HAL was also keen for greater transparency on costs of the gate-to-gate ANS. HAL thought greater transparency would facilitate a competitive tendering process for terminal ANS.
- 5.13 HAL concurred with the CAA's interim report that there may be risks to financial resilience where there was a shared group structure and staff effectively support regulated, commercial and more exploratory commercial type activities. While enabling NERL to deploy resources flexibly, HAL thought that there should be a more transparent approach.
- 5.14 HAL thought that the CAA should consider both voluntary undertakings and potential licence modification to address risks, with voluntary undertakings being the most flexible and probably the initial basis on which to proceed. HAL supported good governance, but thought mandated governance through the licence was probably not the appropriate mechanism.
- 5.15 In the stakeholder meeting the CAA received representations that businesses continually sought to improve efficiency because of the fear of financial failure. Furthermore, the CAA heard the stakeholder view that, although undesirable, financial failure of NATS should be a possibility because the Air Traffic Administration regime was sufficient to protect users: it should be clear that NATS would be allowed to become insolvent if it were inefficient or subjected itself to undue financing risks.

(c) DiscussionCAA reflections on stakeholder representations

- 5.16 The CAA notes that Legislative and Regulatory Reform Act 2006⁹ does not require the CAA to comply with the Better Regulation Principles in its economic regulation of NERL under Part 1 of the Transport Act 2000, although under the Regulatory Enforcement and Sanctions Act 2008 the CAA has a duty not to impose or maintain unnecessary burdens. The CAA agrees that its regulation should be consistent with the Better Regulation Principles. It does not, however, accept NATS' view of the implications of these principles in this context.
- 5.17 The CAA wishes to take an approach which increases NERL's resilience to risk whilst securing that NERL will not find it unduly difficult to finance activities authorised by its licences. The CAA agrees with NATS that in understanding the level of risk it is important to consider the mitigations in place. However, the CAA would need to consider the reliance it could place on risk mitigations where it has no direct or indirect influence or control over whether those mitigations remain in place. The CAA may legitimately therefore adopt a different view on this matter from that held by NERL.
- 5.18 The CAA disagrees with NATS' proposed definition of acceptable risk. The hurdle set for the proposed test appears extremely high, and would imply that the CAA could only intervene if it thought that there was a greater than 50% probability that NERL would not have sufficient financial and non-financial resources. Furthermore it is not clear what NATS would consider to be a 'material breach' of its licence.
- 5.19 NATS sets out two further tests including 'minimum remedial action' and a cost benefit analysis from the perspective of all stakeholders. In respect of the first, the CAA notes that proportionate regulation is one of the Better Regulation Principles that the CAA would expect to follow. In respect of the second test, the CAA considers that its economic regulation duties are in respect of users of NERL's services and therefore the cost benefit analysis should be from this perspective. Therefore, any action which affects other stakeholders is taken into account to the extent that it has consequential effects on users, for example through charges or service quality.
- 5.20 The CAA notes that the staffing structure and the related consents have been in place since PPP. However, the CAA does not consider that this fact alone makes them immune to review.
- 5.21 The CAA welcomes NATS' acknowledgement that there is a range of regulatory tools that could be used to address the CAA's concerns, one of which is voluntary undertakings. The CAA does not rule out the use of voluntary undertakings if it is persuaded this is the most proportionate remedy to the risk(s) it has identified.

⁹ Statutory Instrument 2007 no 3544

- 5.22 The CAA questions how strengthening NERL's governance could raise the possible expectation compensation for affected shareholders. The CAA welcomes the suggestion from NATS that existing non-executive director roles could be adapted to provide additional governance of NERL and will consider whether this would be sufficient to address the CAA's concerns with the governance of NERL and its independence from other group companies such as NSL. The CAA is concerned that, while the NATS Board makes decisions in the best interests of the NATS group of companies as a whole, there may be no independent voice examining whether these decisions are in the best interests of NERL – the regulated en route business.
- 5.23 The CAA has considered whether it would be appropriate for NERL to apply the UK Code on Corporate Governance. The Code is based on a 'comply or explain' approach and, therefore, would give NERL the opportunity not to comply. This could frustrate CAA efforts to strengthen NERL's governance. The CAA considers that its concerns with NERL's governance are quite specific (relating to the independence of NERL decision making) and therefore will consider the appropriateness of a licence condition requiring directors independent of all other group companies and shareholders and any related requirements to make this effective. Further work will be required on this issue.
- 5.24 The CAA notes the Unions' view that ANS in the UK is the core business, and the focus on gate-to-gate services. The CAA also notes the concerns raised by HAL and MAG in relation to the cost transparency of terminal services. The CAA is currently undertaking on behalf of the DfT a contestability study of the terminal market and expects to publish its advice to DfT in February 2013. This will set the scene for whether and how this market ought to be regulated according to the EU Charging and Performance Scheme Regulations.

CAA further discussion of the issues

- 5.25 In the CAA's view, NERL could be thought of as operating a 'whole business' outsourcing arrangement because all staff are seconded from NATS Limited; direction, management and corporate services are provided by NATS Limited; and certain services required under the licence are provided by NSL. For example, under the Master Services Agreement, NATS Limited provides services to NERL including Board support and strategy.
- 5.26 Furthermore, NERL is the sole borrower and issuer of bonds for NATS under a structure similar to a whole business securitisation. NERL has provided security over all its assets and undertakings to providers of finance. NATS Holdings and NATS Limited have also charged/pledged certain assets as security for NERL's debt obligations. Direct and indirect cross-default triggers expose NERL to risks arising elsewhere in the group. The practical effect of these arrangements is that the providers of finance have placed a contractual ring-fence around the NATS Operating Group.

- 5.27 Taken together, the CAA wishes to consider whether these arrangements pose potential risks¹⁰ to the efficient and effective discharge of NERL's functions including continuity of service provision in the event of NERL's insolvency and the CAA's ability to regulate NERL effectively.
- 5.28 These risks are exacerbated by the NATS governance arrangements, by the potential for the transfer of significant control to creditors in the event of financial distress and by the fact that the consents given by the CAA expire on the expiry of the financing to which they relate and hence are long-term in nature.
- 5.29 Some risk mitigations are in place:
- creditor imposed restrictions on activities, borrowings, distributions etc. This recognises that in many circumstances the interests of creditors align with the interests of users;
 - the ring-fence provisions for which consents have not been granted;
 - the gearing cap and related lock-up provisions;
 - Air Traffic Administration Orders (although it seems likely that the Air Traffic Administrator would need to reach an accommodation with creditors and the administrator of NATS Limited in respect of NERL's continued access to staff);
 - provision for transfer of employees to NERL in event of insolvency of NATS Limited or NSL;
 - Government consent is required before any enforcement of security granted by NATS or NERL; and
 - creditor undertakings to the CAA in respect of enforcement of NATS security.
- 5.30 However, these may be only partially effective (and may fail under conditions of financial stress) because NERL remains dependent on staff and other resources (such as senior management time) and commitment of other group companies and therefore remains exposed to intra-group risks unrelated to its regulated activities.
- 5.31 The CAA has not been able in the time available to conclude definitively how best to take forward the mitigation of these risks. It has, however, concluded that, given the nature of the risks and the potential risks involved in making changes in this area, further work on proportionate remedies is necessary. It has also set out below some observations that will frame a further programme of work on NERL's governance and financial ring fencing which will be taken forward by the CAA in 2013. In the event that the CAA wished to take forward any options that would require modification of NERL's licence, the CAA would follow a consultation process prior to such a modification proposal. NERL would be able to reject any such proposal, in which case the CAA would be able to refer the matter to the Competition Commission.

¹⁰ For example, TUPE might mitigate some of these risks.

5.32 In the following sections, the CAA sets out some options which it has ruled out and some which it considers worthy of further consideration and investigation with NATS.

Options ruled out

5.33 The most effective means of restoring a full and effective ring-fence would be to withdraw the existing consents. The CAA has considered this approach and rejected it because it seems likely that this would constitute an event of default under the existing financing arrangements and force NATS into a financial restructuring. The CAA considers that this is not a practicable option in the current market context and would be very costly and disproportionate (even if an extended period of grace were to be allowed). The CAA also considered, but has ruled out, proposing a licence modification to require NERL to employ its own staff directly rather than through the current arrangements with NATS Limited.

Options worthy of further consideration

5.34 There are various options that the CAA would like to see considered either individually or in combination. These options can be broadly grouped into 'preventative' and 'curative' approaches. The CAA is not currently expressing a view on the merits of the various options. An evaluation should be considered as part of the future work programme on NERL governance and financial ring fencing.

i. Preventative approaches

5.35 The options under this approach, set out below, are aimed at preventing a situation of financial distress in NERL occurring. These options could potentially be implemented by licence conditions, voluntary undertakings and/or additional CAA guidance on existing licence conditions.

- Introduce a requirement on NERL pro-actively to confirm compliance with all (or specified) parts of Condition 5 of its licence before paying dividends.¹¹
- Strengthen the requirements on NERL to procure from its ultimate controllers a legally binding assurance that they will do nothing to undermine NERL's ability to comply with its licence.
- Draw a ring-fence around either the whole of the NATS Operating Group or its UK activities. The licence currently places restrictions on the activities of NERL only. This could be extended to restrict activities of all group entities party to the financial arrangements of NERL. In effect this would bring them within the ring-fence. NATS could continue to pursue any business venture outside of this ring-fence without any involvement of the CAA. In effect this might mean all UK ATM activities, including staff, are in the ring-fence and all non-UK or non-ATM activities are outside the ring-fence.

¹¹ Condition 5: Availability of Resources and Financial Ring-Fencing.

- Require NATS Holdings to underwrite the performance of group service providers on which NERL depends for any resources or services necessary for to enable it to perform its licensed functions.
 - Obligate NERL to do nothing that would frustrate the smooth and timely operation of an Air Traffic Administration Order (Special Administration). This could be extended by obligating NERL to ensure it keeps an up-to-date and robust continuity of service plan in place in the event of financial distress in either its business or related NATS businesses.
 - Some options might require NERL to use its best endeavours to obtain undertakings from its parent companies (NATS Limited and NATS Holdings) or its ultimate shareholders. Examples where such undertakings are worthy of further consideration include:
 - Currently the cross-default provisions in the financing arrangements do not directly link NERL and NSL, but do link NERL and NATS Limited (NATS Limited is the parent company of both NERL and NSL). One way to lessen the risk bridge from NSL to NERL would be for NATS Limited to undertake to refrain from providing any guarantees to other parties in respect of NSL's performance.
 - The CAA could seek to 'piggy-back' on the negative undertakings NERL has given its secured creditors. These are more restrictive than the current restrictions imposed under its licence.
 - Introduce a requirement for routine reporting by NERL of the risks it faces and the mitigations that are in place by virtue of its intra-group relationships. This qualitative analysis would include those risks originating from elsewhere in the NATS group. The purpose of this would be to put NERL under an obligation to proactively identify, manage and report on the risks to its business from its financial, staffing and other links with other businesses controlled by NATS Holdings.
- 5.36 These options are in addition to the recommendation the CAA made in its Interim Report that it should subject NERL's certificate of resources (a requirement of the Licence Condition 5) to greater regulatory oversight and scrutiny. In this regard, the CAA will wish to understand in more detail NERL's views on how it considers that its whole outsourcing model enables it to ensure it has adequate resources.
- 5.37 The CAA also wishes to consider further actions it could take to strengthen the governance of NERL. In particular it wishes to consider the advantages and disadvantages of NERL being required to have one or more directors who are independent of all other NATS companies and shareholders.
- 5.38 Finally, the CAA would be willing to work with NATS if NATS thought that a staff restructuring was an appropriate solution to the issues identified and was prepared, on a voluntary basis, to consider alternative staffing models.

ii Curative approaches

- 5.39 These options relate to ensuring that in the event of financial distress the CAA can discharge its duties under the Act and there is a smooth and successful process of Air Traffic Administration.
- 5.40 The CAA would be interested in holding discussions with NERL and its lenders to potentially amend the current staffing arrangements in the event of an Air Traffic Administration Order. For example, while noting that the CAA has issued consents and the Intercreditor Agent provided undertakings¹² based on the current arrangements, the CAA would be interested in exploring whether these undertakings could be extended, by mutual agreement, to include the requirement to obtain¹³ the:
- consent of NERL and the Air Traffic Administrator (if one has been appointed) to the suspension (or termination) of the group service provision arrangements; and
 - co-operation of (i) NERL and the Air Traffic Administrator (if one has been appointed) and (ii) of NATS Limited and of any Administrator, Receiver or Liquidator of NATS Limited (if one has been appointed), to procure transfer of staff (and other required resources) from NATS Limited to NERL in event of financial distress at either NERL or NATS Limited.

(d) Conclusions of the *ad hoc* review

- 5.41 The review concludes that it would not be appropriate for the CAA to seek to alter the existing arrangements such as to impose a full conventional ring-fence. Instead, the review has taken a pragmatic approach and set out some options that could improve the resilience of service provision without imposing undue costs.
- 5.42 The CAA notes that these issues need further consideration and this Final Report does not reach firm conclusions. Rather this report sets out the CAA's views on a set of options that warrant further evaluation in a detailed work programme that will be launched in 2013, led by the CAA's Regulatory Policy Group. The three recommendations (numbers 6, 7 and 8) set out in the Interim Report in relation to sufficient resources have been combined into one in the final report.

¹² In effect these mean that lenders cannot enforce security given by NATS Holdings, NATS or The Airline Group without written consent of the Secretary of State and giving the CAA 14 days' notice.

¹³ so far as it is within the power of the Intercreditor Agent or of the creditors by whom the Agent is appointed.

Figure 5.1: Conclusions and actions to pursue the CAA's strategic outcome on NERL maintaining sufficient resources**Conclusions and actions**

6. The CAA does not consider that withdrawing financial ring fencing consents would be in users' interests. Nor does it consider it appropriate to force a restructuring of NATS staffing model. On the other hand, the CAA is not content to 'do nothing' about the financial risks NERL is exposed to by virtue of its relationships with other NATS businesses. In 2013, the CAA will launch a detailed review of the options for strengthening NERL's financial resilience. It expects this will focus on both 'preventative' and 'curative' approaches. If this review results in proposals to amend the NERL licence, the CAA will consult stakeholders in the usual way. 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. The CAA's forthcoming review of NERL's ring-fence should also consider in more detail the options for strengthening NERL's governance. In particular, it should consider the merits of introducing obligations on NERL to ensure it has one or more directors that are independent from any other NATS businesses and shareholders.

Source: CAA

6. Strategic capabilities for the future

Strategic outcome:

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

(a) Interim Report

- 6.1 The CAA set out two draft recommendations. The first related to the need for there to be a clear industry wide map of accountabilities and responsibilities of the various players so all stakeholders were clear what was expected of whom by when. The second related to the merits of the FAS Industry Implementation Plan (FASIIG) being a key input into the CAA's review of the NERL price control for RP2 and gaining a better understanding of the commercial incentives and business cases of various FAS related initiatives.

(b) Representations

- 6.2 In NATS' response there was a strong emphasis on the CAA providing leadership to the FAS, including its deployment. NATS welcomed the CAA's recognition of the interaction between FAS deployment and RP2. The deployment of FAS will require investment from a number of the key parties including NERL and therefore the operating and capital expenditure implications will need to be considered in the RP2 review. Without adequate funding through RP2, NERL said it may not be in a position to support the deployment of FAS projects.
- 6.3 Given the focus on reducing prices for RP2, NATS said it will also be critical for the cost benefit analyses and regulatory impact assessments for FAS projects to be clear and compelling to gain customer support during the RP2 consultation and to inform discussions around the trade-offs between price and quality of service and other benefit delivery. NATS noted that the FAS benefits may not directly accrue to NERL or its customers but, that the cost of achieving such benefits may nevertheless, be viewed as candidates for funding through the unit rate.
- 6.4 HAL thought that there were three important steps for the successful implementation of FAS. A suitable governance structure: FASIIG is an important pan-industry consultative body, however its membership does not constitute a decision making entity. HAL supports the creation of an industry lead deployment manager to ensure that the key deliverables (aligned to the SESAR programme) are put in place in a timely and effective manner. Finally, HAL said the CAA and/or the DfT should be

empowered to act when the quality requirements or the timescales behind each key deliverable were not being met.

- 6.5 HAL was keen for the CAA to take the opportunity to secure greater alignment around the funding of the FAS and hence SESAR deliverables through the RP2 price control. This should include a cost-benefit analysis that all stakeholders can sign up to. The CAA should also link this to airport regulation and consider how sufficient motivation could be given to airports not subject to economic regulation where the FAS success is reliant upon their participation and funding. Without such motivation, it is possible that the deployment of the FAS and, in turn, SESAR will become compromised and efforts made by regulated airports will be negated because system and network improvements cannot progress as solution delivery becomes fragmented.
- 6.6 The Unions representing NATS employees broadly agreed with the draft recommendations.

(c) Discussion

- 6.7 The CAA is keen to ensure that NATS has appropriate incentives to deliver its full contribution to the FAS in a timely way. The CAA agrees with NATS that there needs to be more clarity in RP2 as to how the costs associated with strategic investments should be recovered. The CAA is mindful that for some programmes the costs may be incurred in RP2 but the benefits may only flow to airspace users in RP3 and beyond. NATS suggested that the expenditure related to the FAS should be considered as part of the discussions on RP2 because it thought that without adequate funding, NATS may not be able to support FAS projects. The CAA does not consider that all FAS projects should simply result in additional revenue allowances in the price control, albeit this might be case for some programmes.
- 6.8 The CAA considers that its approach should be influenced by a number of factors.
- *A clear legal basis under the SES Charging and Performance Regulations.* Such investments would need to be identified and justified as part of the UK-Ireland FAB plan and hence subject to scrutiny by the PRB and European Commission. The CAA expects the Commission and PRB will want to see how the investments align with the ATM master plan and potential trade-offs with the objective of greater cost efficiency in RP2.
 - *A clear cost-benefit case.* Major FAS-related initiatives undertaken by NERL should have a demonstrable business case in terms of net benefits to airspace users over time. With airspace users demanding a rigorous focus on cost efficiency for RP2, NERL (and/or the CAA) will need to identify and explain the benefits of programmes that add to costs in the short term (or else prevent cost reductions). In looking at the detail of the costs the CAA will need to assess

whether they should be treated as operating expenditure and charged in the year incurred or capitalised and recovered over an appropriate period of time.

- *A consideration of business-as-usual requirements versus new responsibilities.* The CAA will need to assess whether the programmes should be considered as business-as-usual for NERL or whether they should be considered outside business-as-usual as new responsibilities that warrant an additional revenue allowance.
- *A consideration of 'high powered' regulatory incentives.* The CAA will need to consider how it can best incentivise NERL to deliver the required strategic capabilities within RP2. There are a number of options that could be considered. For example, if the CAA thought that a FAS initiative should be taken forward as part of NERL's business as usual and its outcomes could be clearly specified it could be incorporated in the NERL licence as an explicit condition or as part of a service quality incentive scheme. Alternatively if an initiative was considered not business as usual and should attract an additional revenue allowance, the CAA would need to consider how it could secure its required outcomes, for example by setting targets with rebates if NERL fails to deliver the required outcomes in a timely way.

6.9 The CAA accepts there is a need for the CAA, through the FASIIG, to define with greater clarity the respective roles and accountabilities of various stakeholders including the CAA. This will help address the points made by NATS and HAL in relation to sector governance and leadership.

(d) Conclusions of the *ad hoc* review

6.10 Figure 6.1 sets out the CAA's conclusions on the actions it will take in pursuit of the outcome of ensuring NERL develops required strategic capabilities for the future. It makes minor changes to the draft recommendations to confirm them as conclusions. Action 7 strengthens the wording in relation to ensuring the CAA develops for RP2 incentives on NERL to deliver the required strategic capabilities and that this is taken into account when developing the price control for NERL for RP2.

6.11 The CAA intends to take forward these actions through the business plans for its Directorate of Airspace Policy and its Regulatory Policy Group. They will continue to work closely together to ensure that the next NERL price control takes into account appropriate incentives to deliver the required capabilities established by the FASIIG plan.

Figure 6.1: Conclusions and actions to pursue the CAA’s strategic outcome on NERL capabilities for the future

Conclusions and actions	
7.	Given that significant industry-wide collaboration is needed to deliver FAS initiatives, the CAA will, through the FASIIG, develop a clear map of accountabilities and responsibilities of the various players so all stakeholders are clear what is expected, from whom, and by when and the appropriate governance structures.
8.	The FASIIG plan will be a key input for 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 the CAA will gain a better understanding of the business case for various FAS initiatives from both a private NERL perspective and a wider industry perspective. The CAA will also consider how NERL’s regulatory incentives to deliver certain FAS initiatives can be strengthened in the NERL price control settlement for RP2.

Source: CAA

7. Clarity on NERL's regulatory obligations

Strategic outcome:

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

(a) Interim Report

7.1 The CAA set out two draft recommendations. The first draft recommendation related to clarifying certain ambiguities in the NERL licence with respect to the drafting of the Specified Services. It also suggested that the CAA should continue to roll out its MOCOR framework to ensure there was clarity on the purpose of the nature of the CAA/NERL relationship in every interaction across the CAA's various groups. The second draft recommendation said there was 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. The Interim Report also suggested that there may 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.

(b) Representations

7.2 There was little comment from stakeholders on this strategic outcome.

7.3 NATS supported a review of the Specified Services in order to remove any ambiguities in its licence.

7.4 The Unions that represent NATS employees noted the processes involved in the regulation of NERL are mature and the principles are well understood including a range of incentives and penalties to support and underpin the appropriate behaviours by NERL. They considered that there is no evidence to suggest the need beyond this for the use of civil sanctions or penalties as part of the enforcement regime.

(c) Discussion

7.5 The CAA welcomes the fact that its draft recommendations in this area appeared uncontroversial. It notes the views of the Unions in relation to the need for civil sanctions: however the current system of incentives is limited to the CAA's economic regulation of NERL whereas there may be benefit in the CAA being granted a graduated set of civil sanctions across all of its regulation of NERL (and NSL where relevant). This is because some of the present sanctions such, as revocation of an ANSP's certification, may be seen as disproportionate for all but the most serious problems but there may be instances in which no lesser penalty or sanction is

available. Accordingly, the CAA remains of the view that this recommendation is valid.

(d) Conclusions of the *ad hoc* review

7.6 Figure 7.1 sets out the CAA's conclusions and the actions it will take in pursuit of the outcome of ensuring there is clarity on NERL's regulatory obligation and relationships with the CAA. It makes only minor changes to the draft recommendations to confirm them as conclusions.

7.7 Action 8 will continue to be undertaken by the CAA's Directorate of Airspace Policy. Since the publication of the Interim Report the CAA has continued to work with NERL on a joint review of the Specified Services. The project is due to conclude in the first quarter of 2013. Action 9 will be undertaken by all the CAA groups that have a role in regulating NERL.

Figure 7.1: Conclusions and actions to pursue the CAA's strategic outcome of clarity on NERL regulatory obligations and relationships with the CAA

Conclusions and actions	
9.	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, CAA will continue to undertake with NERL 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. The CAA will continue to roll out throughout its organisation its MOCOR framework and encourage NERL to do likewise.
10.	The CAA will discuss 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. The CAA will also raise 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.

Source: CAA

8. Ownership neutrality

Strategic outcome:

The 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) Interim report

8.1 There were no draft recommendations for this strategic outcome. Instead the CAA considered that this outcome could be achieved as a result of successful pursuit of other draft recommendations, especially those in relation to strengthening NERL's governance and financial ring-fencing.

(b) Representations

8.2 NATS thought that the CAA had three concerns with the ownership structure and framed its response around these: a change in the type of ownership (from a Strategic Partnership with Government to some other form of equity ownership); a change in the identity of the Strategic Partner (from the Airline Group to another); and the extent to which these concerns are exacerbated by the CAA's perception of the effectiveness of the current financial ring-fence.

8.3 NATS argued that any attempt to render NERL and its licence neutral to the concept of a Strategic Partner¹⁴ would necessarily involve wholesale changes to the existing corporate and related financing structure (including the security package for its debt financing). NATS noted that the Government had recently announced it has no current plans to reduce its shareholding in NATS.

8.4 NATS noted that the Secretary of State has the discretion to terminate the Licence if the proposed new Strategic Partner were to fail to fulfil the (mainly national security) criteria set out in Schedule 3 to the Licence. NATS said that it was not clear to it to what extent the CAA currently relies on either that discretion or any independent CAA assessment based on the identity of the Airline Group in order to support its regulatory decision making.

(c) Discussion

8.5 The CAA does not consider that NATS' representations invalidate its recommendation that it should seek a regulatory framework that can achieve its desired outcomes regardless of the ownership of NERL (or NATS). It cannot control

¹⁴ The strategic partnership is reflected in the corporate structure, the financing structure and the share ownership of NATS Holdings: the Airline Group, the Government, BAA and employees.

ownership and therefore it has to be satisfied that it has sufficient regulatory levers to achieve its objectives regardless of who owns the company. There are no specific actions associated with this as the CAA continues to believe it can be pursued by successfully achieving the other strategic outcomes.

- 8.6 The CAA notes NATS' comments on the potential implications of wholesale changes to the corporate and financing structure. This is one of the reasons why the CAA is not pursuing the full implementation of a conventional regulatory ring-fence. However, the CAA does not agree that wholesale changes are the only options and has identified alternatives in Section 5.
- 8.7 The CAA notes the Government has said that it will not at the present time sell down its equity shareholding. This does not preclude a future sale. Nor does it preclude other shareholders from considering selling part or all of their equity.

(d) Conclusions of the *ad hoc* review

- 8.8 There are no additional specific actions to pursue this strategic outcome in relation to ownership neutrality but the importance of achieving this outcome underlines the need for many of the actions set out elsewhere in this report. Figure 8.1 sets out the action the CAA will undertake to ensure it periodically reviews its regulatory frameworks to ensure that these remain fit for purpose and in line with Better Regulation Principles.

9. Conclusions of the *ad hoc* review

Figure 9.1: Summary of CAA's conclusions and actions

Conclusions and actions	
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. The CAA will periodically review its regulatory frameworks to ensure they remain fit for purpose and in line with Better Regulation Principles.
2.	The CAA will 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. The CAA will subject NERL's plans to increased regulatory oversight and scrutiny. The CAA will also subject 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.	With NERL increasingly collaborating with international partners and NSL seeking to expand its business in the UK and abroad, the CAA will 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 will 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. The CAA expects this to result in challenging, but achievable, targets for NERL. NERL must prepare to respond positively to 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. The CAA will review NERL's costs, including an appropriate cost of capital, as part of its preparations for RP2.
5.	With airspace users expecting NERL to reduce the indirect costs it imposes on them as well as its direct charges, the CAA will work with stakeholders - in the context of the forthcoming study by the European Commission - to explore and promote more intelligent ways of measuring the inter-dependencies between various key performance areas.
6.	The CAA does not consider that withdrawing financial ring fencing consents would be in users' interests. Nor does it consider it appropriate to force a restructuring of NATS staffing model. On the other hand, the CAA is not content to 'do nothing' about the financial risks NERL is exposed to by virtue of its relationships with other NATS businesses. The CAA will launch a detailed review in 2013 of the options for strengthening NERL's financial resilience. It expects this will focus on both 'preventative' and 'curative' approaches. If this review results in proposals to amend the NERL licence, the CAA will consult stakeholders in the usual way. 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. The CAA's forthcoming review of NERL's ring-fence should also consider in more detail the options for strengthening NERL's governance. In particular, it should consider the merits of introducing obligations on NERL to ensure it has one or more directors that are independent from any other NATS businesses and shareholders.

Conclusions and actions (continued)

7. Given that significant industry wide collaboration is needed to deliver FAS initiatives, the CAA will, through the FASIIG, develop a clear map of accountabilities and responsibilities of the various players so all stakeholders are clear what is expected, from whom, and by when and the appropriate governance structures.
8. The FASIIG plan will be a key input for 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 the CAA will gain a better understanding of the business case for various FAS initiatives from both a private NERL perspective and a wider industry perspective. The CAA will also consider how NERL's regulatory incentives to deliver certain FAS initiatives can be strengthened in the NERL price control settlement for RP2.
9. 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, CAA will continue to undertake with NERL 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. The CAA will continue to roll out throughout its organisation its MOCOR framework and encourage NERL to do likewise.
10. The CAA will discuss 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. The CAA will also raise 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.

Source: CAA

Annex I: Glossary

AG	The Airline Group Limited (a shareholder of NATS Holding)
ANO	Air Navigation Order
ANS	Air Navigation Service
ANSP	ANS Provider
ATAO	Air Traffic Administration Order
ATCO	Air Traffic Controller
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
FAB	Functional Airspace Block
FAS	Future Airspace Strategy
FASIIG	Future Airspace Strategy Industry Implementation Group
HAL	Heathrow Airport Limited
IAA	Irish Aviation Authority
IATA	International Air Transport Association
ICAO	International Civil Aviation Organisation
LAMP	London Airspace Management Programme
The Licence	The licence issued to NERL to provide en route air traffic services in the UK, under the Act.
MAG	The Manchester Airport Group plc
MOCOR	Maturity of Cross Organisational Relationships
NAO	National Audit Office
NATS	NATS Holdings and its direct and indirect subsidiaries, associates and joint ventures
NATS Holdings	NATS Holdings Limited
NATS Operating Group'	NATS Limited, NERL, and NSL and their direct and indirect subsidiaries
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
RP1/2/3	Reference Period 1 (2012-2014), 2 (2015-2019) and 3 (expected to be 2020-2024)
SES	Single European Sky
SESAR	Single European Sky ATM Research
SMS	Safety Management System
SoS	Secretary of State
SPA	Strategic Partnership Agreement
VORs	VHF omnidirectional radio (a radio navigation system for aircraft)

Annex II The CAA's statutory duties under the Transport Act 2000

2 CAA's general duty

1. The CAA must exercise its functions under this Chapter so as to maintain a high standard of safety in the provision of air traffic services; and that duty is to have priority over the application of subsections (2) to (5).
2. The CAA must exercise its functions under this Chapter in the manner it thinks best calculated—
 - (a) 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;
 - (b) to promote efficiency and economy on the part of licence holders;
 - (c) to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences;
 - (d) to take account of any international obligations of the United Kingdom notified to the CAA by the Secretary of State (whatever the time or purpose of the notification);
 - (e) to take account of any guidance on environmental objectives given to the CAA by the Secretary of State after the coming into force of this section.
3. The only interests to be considered under subsection (2)(a) are interests regarding the range, availability, continuity, cost and quality of air traffic services.
4. The reference in subsection (2)(a) to furthering interests includes a reference to furthering them (where the CAA thinks it appropriate) by promoting competition in the provision of air traffic services.
5. If in a particular case there is a conflict in the application of the provisions of subsections (2) to (4), in relation to that case the CAA must apply them in the manner it thinks is reasonable having regard to them as a whole.
6. The CAA must exercise its functions under this Chapter so as to impose on licence holders the minimum restrictions which are consistent with the exercise of those functions.
7. Section 4 of the Civil Aviation Act 1982 (CAA's general objectives) does not apply in relation to the performance by the CAA of its functions under this Chapter.

Annex III: Draft recommendations

The table below is reproduced from the CAA's Interim Report published in September 2012.

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.

Source: CAA