



**PROSPECT AND PCS SUPPLEMENTARY COMMENTS
ON THE CIVIL AVIATION AUTHORITY'S
FIRM PROPOSALS FOR
NATS PRICE CONTROL REVIEW 2006-2010 (CP2)**

July 2005

Introduction

1. Prospect and PCS are the two trade unions representing all 5000 employees of National Air Traffic Services (NATS), including all air traffic controllers, assistants, systems specialists (engineers and scientists), and support staff. All the members we represent are key stakeholders in the future viability of NATS, and therefore have a direct interest in the price controls that will apply to the NATS En-route Ltd (NERL) business during Control Period 2 2006-2010.
2. In February 2005 we submitted formal comments on the CAA Economic Regulatory Group's Initial Proposals as published on 30 November 2004. Prospect and PCS have carefully considered the `Firm` proposals as published on 24 May. Whilst we acknowledge that the CAA have attempted to address some of the key concerns that we had expressed in our submission to the Initial proposals, both in commentary within the Firm proposals, and directly at the industry seminar held on 16 June, we continue to have concerns about the overall impact of the CAA's price control proposals and for that reason wish to submit some supplementary comment before the CAA formally issues its licence modification under Section 11 of the 2000 Transport Act.
3. Whilst Prospect and PCS have openly expressed criticisms of the impact of Economic Regulation on NATS and the members we represent in NATS, we do wish to place on record our appreciation of the open and participative way in which the Economic Regulatory Group of the CAA has conducted consultation on the Price Control Review for Control Period 2. Our comments on the Firm proposals reflect a genuine and deep seated concern that the financial constraints on the regulated NERL and Oceanic businesses within NATS will impact on NATS ability to successfully grow the business in an increasingly competitive market; and will detrimentally impact on all employees, which will inevitably affect service delivery. We are also firmly of the view that it is inappropriate to use economic regulation to influence operational decision making in the delivery of air traffic services, which we believe will compromise the overriding safety culture by allowing financial considerations to become a factor when managing air traffic delays.

Economic Regulation in the Context of Europe

4. Prospect and PCS commented in our submission on the Initial proposals that NATS is the only Air Navigation Service Provider in Europe that is economically regulated, and as such should not be disadvantaged to the detriment of UK interests in the development of the Single European Sky. Whilst recognising the purpose of the CAA's role under Section 2 of the Transport Act 2000 to further the interests of NATS users (principally the airlines), because NATS is considered to be a private operator working in a `monopoly` business of providing en-route air traffic services, it is now very evident that a competitive market for provision of en-route services is developing through the Single European Sky legislation, and in particular the requirement for collaboration on Functional Airspace Blocks (FAB's).

5. It is essential for UK interests that NATS is at the forefront of developments for creating the Single European Sky, which will require speculative investment and financial flexibilities during the next crucial five years of making a reality of the Single European Sky. Yet during this period NATS will be constrained by:-
 - The Maximum Allowed Controlled Revenue as calculated by the CAA in accordance with paragraphs 2-4 of Condition 25 of the Licence, requiring:-
 - Real reductions in allowed operating expenditure;
 - Risks of financial penalties attached to pre-determined minimum delay targets;
 - Continued external pressures on its Capital Investment Plans to renew and replace the air traffic controlled infrastructure.

In that context we would want to see a caveat included within Condition 25 (Suspension and Modification of Charge Control Conditions) within the Licence under Section 11 of the Transport Act 2000 so that there can be scope for easing the economic requirements of the CP2 proposals in order to meet as yet unforeseen additional expenditure and/or operating flexibilities required to assist NATS to deliver its strategic and operational objectives within the Single European Sky.

Operating Expenditure Limits

6. A key aspect of the CP2 proposals are the required reductions in NATS operating expenditure. Paragraph 7.43 of the Firm proposals states that NATS *"over the 5 years of CP2, the CAA's proposed OPEX allowances are approximately £26 million or 1.5% less than the forecast contained in NERL's March 2005 business plan"*. CAA argue that this reflects a substantial narrowing of the gap between the Initial proposals and NERL's revised expenditure projections as published in their March 2005 business plan. When we questioned CAA representatives about this aspect of the proposals at the industry seminar held on 16 June, CAA emphasised that the difference between NATS and CAA was quite narrow. However, in examining the proposals in more depth in relation to the 2005 NATS business plan it is now evident that the overall requirement for NATS over the next 5 years will be to achieve around **£150 million** of cost savings in that period, which does represent a significant reduction compared to current expenditure in the NERL business. It is apparent that NATS had taken account of CAA Initial proposals, as published in November 2004, in drafting their 2005 business plan and by assuming the anticipated reductions that will be required in operating expenditure had given themselves a commitment to reduce expenditure by an additional £106 million (in profit & loss terms) over the next 5 years. Over and above that requirement CAA now expects an additional reduction of £26 million (in cash terms) which equates to £35 million in profit & loss accounting terms.
7. Given that almost two thirds of NERL's operating expenditure are staff-related costs, because of the high skills level required to deliver Air Traffic services, then the overall operating expenditure proposals will have a disproportionate impact on NATS employees. As we argued in our submission to the Initial proposals, if the affects of the reductions in operating expenditure is to force cost-cutting measures on staff-related expenditure and constrain opportunities for productivity-based investment in staff, then the net affect of these changes would be to damage rather than challenge NATS ability to meet the service quality targets. It is now evident to Prospect and PCS, and the 5000 members we represent in NATS, that the required reductions in operating expenditure will be extremely difficult to achieve and will impact on morale, motivation and hence service delivery. Prospect and PCS do have a constructive relationship with NATS and have been engaged in detailed discussions on 'working together' to meet the challenges posed by CP2, but the fact remains that expenditure reductions of that magnitude will be difficult to achieve

and, irrespective of our commitment to constructive engagement with NATS, will cause considerable internal tensions and risk imposing a practical constraint on NATS ability to grow the regulated business.

8. CAA's initial proposals acknowledge that ATCO productivity 'appears to be significantly better in NATS compared to other European ANSPs' and that 'overall head count in corporate functions found that staffing levels within NERL generally compare favourable with other firms'. As we said in our initial submission, all of this gives a clear indication that NATS and its employees have been firmly committed to join the improving service delivery and productivity of the past 2 years, which again underlines the importance of creating a good climate for industrial relations and staff cooperation, which cannot be assumed to be a 'given' throughout CP2. Reducing allowed operating expenditure by the total amounts now required will cause considerable difficulties for NATS and the highly skilled staff required to deliver that business affectively. **It is essential that the price control modifications to the NERL licence do permit some financial flexibility so as to provide sufficient operating expenditure for the NERL business – after CAA is satisfied that 'best endeavours' by NATS may not have been sufficient to meet the rigid constraints that are reflected in CAA's Firm proposals.**

Capital Expenditure

9. We welcome CAA's decision to change its Initial proposals on capital expenditure so as to now allow NATS full access to 100% of the capital expenditure requirement, subject to the continuous programme of monitoring as set out in paragraph 8.40 of the Firm proposals. The current Long Term Investment Plan (LTIP) of NERL is the most ambitious programme of modernisation of the UK air traffic infrastructure ever undertaken, and will give NATS a leading edge within Europe over the next 10 years. The success of that LTIP is dependent on the teams of highly skilled engineers, scientists and other systems specialists employed within NATS. These same individuals will be affected by the CAA's proposals on day to day operating expenditure within the regulated business yet will be required to deliver highly complex technological programmes to time and costs whilst downward pressure on their pay and conditions. We highlight this point to emphasise the inter-dependence of all NATS employees to delivering air traffic control services and the

importance of allowing NERL sufficient financial flexibility to run the business smoothly during CP2.

Delay Targets

10. We note from paragraph 6.21 from the Firm proposals that *"the CAA has considered carefully the points raised by Prospect/PCS and recognises the need to guard against unintended adverse affects on safety in any scheme of efficiency incentives"*. The CAA emphasise that the incentives of delay bonuses and penalties linked to pre-determined targets of air traffic delay are intended to encourage NATS *"to provide enough staff and other resources at peak times or to alleviate particular bottlenecks, so that such incentives are working with rather than against, the achievement of high levels of safety"*. CAA has also emphasised that the incentives that are proposed, including weighted penalties for air traffic delays occurring during the peak morning periods, are *"designed to operate at an aggregated level to avoid affecting operational decisions at the individual flight or ATCO watch level"*.

11. **Despite these reassurances on the intention of the delay penalties, Prospect and PCS remain concerned that safety will be compromised by the threat of significant financial penalties that are directly linked to air traffic delays that occur at peak periods.** We accept and understand that the incentive schemes would be operated at an aggregated level and not on individual shifts – a point that was emphasised to Prospect when we met with the Safety Regulation Group on 3 May to discuss this specific issue. Nevertheless, it is clear that financial penalties of up to £24 million in the context of annual operating expenditure of around £340 million per year represent a significant financial risk to NATS and therefore in order to minimise that risk there will be a wide range of measures taken to avoid at all cost delays occurring during the specified peak morning period, or occurring to individual aircraft beyond 15 minutes of delay. That will include a cultural change in the way that delays are managed, which in turn will lead to indirect pressure to avoid delays that incur significant financial penalties.

12. We reiterate the argument that we put in our submission on the Initial proposals:-

"There is a direct correlation between air traffic delay and safety considerations. Delays attributable to air traffic control normally arise as a

consequence of enforced reductions in traffic flow within particular sections in order that the controllers and systems can cope with the given level of air traffic movements within the available capacity at that particular time. Reducing the flow the traffic is therefore a safety tool to minimise the risk of loss of separation or overload. In that context, the proposals to double the financial penalties tied to NATS delay performance should not be perceived as an incentive to compromise safety by:-

- *Increasing traffic flow when capacity is limited, in order to avoid incurring significant financial penalties;*
- *To give a greater weighting to delay suffered by flights which depart early in the delay;*
- *Additional weighting of the delay penalty for delays greater than 15 minutes”*

Incentive schemes to improve service delivery by reducing delays should be focussed solely on increasing airspace capacity not through a direct measurement of air traffic delay at particular times or on particular individual delays. We do acknowledge that it is not the intention of these incentives to influence day to day operational decisions on traffic flow, what we are emphasising is that the incentive scheme will in itself create a culture of avoiding delays at those peak penalty periods at all costs, and thereby will indirectly influence day to day decisions taken because of the new focus on reducing delays so as to avoid financial penalties.

Treatment of Pension Costs

13. We welcome the categorical statement on page 80 of the CAA's Firm Proposals that for *"employees that join the business during CP2, the CAA has assumed in setting NERL's operating cost allowances that they will be offered the same benefits and existing scheme members and has provided in full for the associated cost to NERL"*. We are pleased that this clears up a concern that the changed basis of treating pension contribution costs for new employees from January 2006 would have been used to effectively introduce a two tier pension scheme. We would have preferred all pension costs (current and future) to be treated as pass through costs but nevertheless welcome the clear statement that the change is not intended to lead to reduced benefits for new employees in NATS.

Conclusion

14. We welcome the opportunity to submit some supplementary comments on the Firm proposals and would again reiterate our appreciation of the open and inclusive way in which the Economic Regulatory Group of CAA has conducted this review of NERL's price controls during CP2. Our overriding concern is about the impact of those financial constraints on NATS and the employees we represent over the next five years. We urge CAA to include a caveat within the modification to the licence, under Section 11 of the Transport Act 2000, so as to provide necessary financial flexibilities during CP2 in order that NATS is able to continue to grow the business and make a reality of its vision to become the leading air navigation service provider in Europe and the rest of the World.

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29.7.05