INTRODUCTION

IATA welcomes the opportunity to respond to the CAA’s initial consultation paper on the approach and scope for the Control Period 3 (CP3) review. As the association with 222 members representing 92% of the world’s scheduled air traffic and some 110 members using UK airspace, we have a significant interest in this review.

We did not believe that the CAA CP2 decisions were sufficiently robust or challenging for privatized and fully commercialized NATS with airline strategic control. This is illustrated by the regulatory returns generated (table 3-7 Chapter 3) for both UKATS and Oceanic that are significantly in excess of those projected by the CAA. Similarly we note that the performance against par value for weighted average delays has substantially exceeded the par value set in the price control and has contributed significant additional bonuses for NATS at the same time as additional traffic has delivered considerable extra revenue. Meanwhile, as the CAA will no doubt be aware, NATS has consistently priced up to their fully allowable cap for both en route and Oceanic.

RESPONSES TO QUESTIONS

Q1 The CAA invites interested parties to comment on the potential usefulness of benchmark analysis to inform the CP3 price control review, and on the CAA’s proposed approach to developing analysis of the available European data on comparative ANSP charge performance.

We fully support the intention of the CAA to aim at drawing on the widest range of relevant information available for the efficiency scrutiny of NERL’s business plan and projections for CP3. In this regard we highly value the work and outputs of the EUROCONTROL Performance Review Unit (PRU) that puts greater emphasis and improved cost-effectiveness of European ATM through its annual Performance Review and ACE Benchmarking reports.

Airlines are not as naïve as the CAA suggests in believing that unit rates are a good proxy for the relative cost-effectiveness of ANSPs. We are well aware that price per Km or cost per flight hour for example are more appropriate measures. Nevertheless it should be noted that there is a very close correlation between the
European ATM unit costs and unit rates. The UK unit rate is after all primarily driven by the NATS costs that are some 86% of the total. All other EUROCONTROL States also have broadly similar proportions of other (EUROCONTROL Agency, Regulatory and MET) costs, and the ACE Benchmarking Reports only scrutinize ANSP costs.

Unit rates still determine the bills that airlines pay and will therefore continue to be closely scrutinized against the background that airlines operating in an increasingly competitive and de-regulated business will naturally seek to choose the least-cost routings when possible.

In regard to available European benchmarking it should above all be recalled that all other ANSPs are still working within the “full cost-recovery” system, which is recognized as having very limited incentive to motivate management or staff to improve efficiency. Comparisons must therefore consider that NATS is a privatized and independently economically regulated entity for which the performance and targets should be significantly more challenging.

While there is some merit in making comparison with the major ANSPs with perceived similarities in size or complexity, it would be very disappointing if for example the exceptionally poor high cost and low-productivity Spanish AENA performance was used to justify NATS relatively high costs.

Neither should broadly similar unit labour costs be automatically used to group suitable ANSPs for comparison. As they are proportionally a very high cost element, labour costs should equally be subject to incentives for improving cost-efficiency, particularly against the background that studies during the CP2 review identified efficiency gaps in expenditure of around 20% relative to comparators from other industries and a tendency to pay higher salaries than would be expected for individuals of comparable experience.

We are aware that NATS maintain airspace complexity is a major reason for their relatively high costs. While we recognise that the London TMA in particular, and Manchester to a lesser extent, have considerable density and complexity, we note that independent PRC reports have indicated that NATS airspace is less complex that Belgocontrol and no more complex that Swiss Skyguide and German DFS for example.

Complexity mainly impacts ATCO productivity and operational costs that are 20% of the total. NATS productivity and operational unit cost performance however is relatively good, indicating that complexity is not an obstacle to productivity or cost-effectiveness. On the other hand NATS is not seen to be performing so well with regard the other support costs that are some 80% of total.

It should be considered however that complexity is also a result of traffic density that enables a positive effect on productivity with a significant reduction in unit
costs from the ability to spread fixed costs over a larger volume of traffic, as well as higher revenues to achieve greater economies of scale.

Given NATS views and motivations on the impact of complexity we believe the CAA should lead on benchmarking. We look forward to the benchmarking against available PRU data and the further analysis the CAA intends to make to ensure robust comparisons of NERL’s performance and the scope for improvement in NERL’s cost-effectiveness in the coming regulatory period.

Q.2 The CAA invites views on which of the two approaches outlined above would enable the CAA better to fulfill its statutory duties.

Q.3 Under the customer consultation approach, the CAA invites views on:
• the suggested structure and governance of the customer consultation process;
• the proposed allocation of issues to NERL-airline consultation and to CAA scrutiny, respectively;
• the timing and balance of the review between customer consultation and the subsequent CAA consultation on regulatory proposals
• the nature of the CAA mandate; and
• suggestions as to the procedures and protocols for consultation which might be incorporated in such a mandate.

Q.4 Do respondents have any other suggestions on how the process for the CP3 review might best be structured to meet the CAA’s regulatory requirements, recognising the scope for and constraints on airline users participating in this process?

We are pleased to note and fully support the CAA’s statutory duty to further the interests of airspace users and to promote efficiency and economy on the part of NERL.

We do not think that the CP2 review imposed a considerable degree of consultation fatigue on airlines through a protracted process or lack of effective engagement. Although we are continually resource-constrained vis-a-vis our providers, in our view the CP2 review was relatively simple and efficient compared for example with the BAA London airports review that also involved the Competition Commission and an extensive number of Constructive Engagement work streams and meetings. It seems there may be some over-playing of this issue to promote the proposed Customer Consultation process as preferable to the CAA-led process.

We agree that NATS has continued to build up the breadth and depth of its engagement with customers. Against the breadth and depth of these arrangements and forums together with the ever-decreasing airline and representative organizations resources, we note that NATS has built up its resources in preparation for the review including the employment of outside
expertise. It should also be noted that NATS generally control or attend all the forums in addition to being the major source of data and information.

If the airlines allegedly suffered from “consultation fatigue” during the CP2 review it needs to be considered that the customer-led approach, with its frequent meetings and work-load within the Working Group arrangements and milestone evaluations process, can be expected to require significantly increased resources with the appropriate expertise.

In these circumstances more than ever we need the CAA to “further the interests of the users and promote efficiency and economy on the part of NERL”. We certainly agree with the CAA statement (5.7) “equally important will be NERL’s actual performance in practice in fulfilling its higher aspirations towards better consultation, supported by the necessary resources and behaviours”. While we could normally be expected to support any approach that involves closer user involvement we do have some reservations and skepticism on the motivations.

We originally welcomed the Constructive Engagement process with the BAA airports for more open and transparent negotiations between airlines and airports on key commercial issues. However, while this generally led to a better working relationship between the airlines and BAA, we were disappointed at the ability to misuse and manipulate the process, including the very late submission of changed data. For such a process to work there is a requirement for a full commitment by both sides to share information and to discuss and respond to issues. Against this background we are please the CAA recognizes (5.14 and 5.15) some of our concerns with the Customer Consultation approach.

In our view the proposed customer consultation process is not a new approach. Most of the key strategic issues, including capacity, delay performance, service and investments together with their financial implications are already consulted and agreed through the well-established SIP process as well as being discussed in forums such as the OPA, SPA and Airline Ops Managers and Directors.

We note that the original concept proposed by NATS and supported by the CAA for “Customer Agreement” has now been down graded to “Customer Consultation”. While this may be a more pragmatic description we hope this does not reflect any dilution in the objective or aspirations.

Given our concerns on the NATS motivations together with airlines’ abilities to devote the necessary technical and financial resources to challenge NATS plans and projections, we can support the customer-led approach on the basis that the CAA will be directly involved in the NATS consultation with the airlines to retain the capability to revert to a regulator-led approach in sufficient time if necessary. This support is also on the basis that the CAA will retain responsibility for the key issues of business risk and efficiency including regulatory finance and the cost of capital.
Q.5 Do respondents agree that Eurocontrol charges need to continue to be controlled by a revenue or price condition?

As a monopoly provider of essential service we believe that NERL’s EUROCONTROL charges should continue to be controlled by price or revenue. In our view there is a strong case for presuming that, providing it is sufficiently challenging and robust, the benefits of price regulation under these circumstances should outweigh the costs.

The 50/50 en route traffic risk share is referred to in 6.6. We fully supported introduction of this facility on a temporary basis as an element of the “Composite Solution” that was necessary to re-finance NATS after the catastrophic impact of “9/11” together with the unsustainably high gearing following on from PPP. Given that NATS is now a profitable and financially sound company, and following the recent successful re-financing together with significantly improved credit ratings, we do not believe that the traffic risk share is necessary.

Q.6 Do respondents agree with the CAA’s preliminary views on the scope of regulation of the London Approach?

In line with our support for the fundamental policy that charges should be cost-related, we have some concerns that the London Approach cost base is cross-subsidised by en route. In principle approach service is provided to aircraft that are arriving or departing from airports and should be allocated to terminal navigation cost bases rather than en route.

However, we are aware that the EC ANS Charging Regulation does allow this and that it is the practice in a number of EC States. We also understand that the EC does not allow subsidies between terminal navigation charges and en route cost bases, so it would be helpful to have clarification on the CAA view regarding London Approach costs and charges.

With regard the NATS proposal to include Luton and London City on the same basis as the three London Approach airports, we tend to agree with the CAA that this approach to solve a relatively minor inconsistency may run the risk that it would add costs outweighing any benefits. We agree the CAA should take account of net revenues from the approach element of the relevant airport contracts as an offset to the general level of EUROCONTROL charges.

Q.7 Do respondents agree that there should be a separate price control for Oceanic services based on a relatively simple and low-cost price review process?
We believe that there should continue to be a separate price control for the provision of Oceanic services. While we are aware this is a relatively small component of NATS business and revenue, it is dominant if not monopolistic and is relatively high cost prepared to other N Atlantic service providers. The review should include some basic benchmarking to better inform this view and the levels of efficiency that should be driven by the subsequent price caps. As the charges are based per flight we do not believe that any volume or revenue risk share is appropriate.

Q.8 Do respondents agree that there should continue to be no price cap for North Sea Helicopter services but the costs and revenues (excluding the East Shetland Basin) should continue to be taken into account in the charging till for setting the en route charge condition?

We have no direct involvement in the N Sea Helicopter services. As with the other elements of the UK ATS single till, we would like assurance that all users pay their fair share of costs without any cross-subsidies.

Q.9 Do respondents agree that it is appropriate for NERL work as part of the SESAR Joint Undertaking to be conducted by the regulated business and recovered through the Eurocontrol charge?

Q.10 What are respondents’ views on how the risks of the SJU should be reflected in the price control?

We fully support the SESAR initiative which we believe is essential to deliver the future capacity, safety, and performance necessary for European ATM as well as an essential element to help reduce the unacceptable cost of fragmentation.

In our view all European ANSPs that have signed up to SESAR have agreed to align their plans and long-term investments with the European master-plan, and we would not therefore expect significant additional costs. Neither would we expect to see any additional costs for R&D activity that is done “in kind”.

We do have concerns that ANSPs can use this opportunity to increase their allowable revenue and returns. As with other cost “pass throughs”, putting such costs into the “single-till” could reduce the incentives to appropriately manage project risks and costs.

The inclusion of any justified costs to be recovered through the EUROCONTROL charge must therefore be subject to robust safeguards on the risks to users in terms of SJU project management and future payments for any assets developed through the SJU. Against this background neither do we believe there is any justification for rolling-forward retrospectively any sums forward for recovery. We
also expect assurance that NATS revenues from SESAR will be passed back to the users through the EUROCONTROL charge.

Q.11 Do respondents agree that the CAA’s approach described above represents a workable approach for the medium term, which is sufficiently flexible to accommodate currently foreseeable change?

We believe that the CAA’s views are a workable approach. Airline users regard FABs as the primary means to reduce the currently unacceptable cost (EUR 5b a year) of fragmentation in European ATM. Unfortunately, as recognized by the EC and PRU as well as the airline users, none of the nine proposed FABs currently have the required ambition or scope to address this objective.

In our view the current FABs proposals are mainly for political/cosmetic purposes without any robust targets to deliver significant cost savings and efficiency benefits above the obvious fuel/delay costs. While we of course welcome the operational benefits, these should and could be delivered whether or not FABs existed. The CP3 framework should therefore be sufficiently flexible to enable the necessary cost-savings to be achieved.

Q.12 What are respondents’ views on the balance of incentives facing NERL and the potential risks to users in the development by NERL of new products?

Q.13 What are respondents’ views on the regulatory incentives and/or constraints which might be placed on NERL during CP3 in this respect?

With regard to differential charging according to aircraft equipage we do not believe there is any requirement to impose incentives on airlines that operate in an intensely competitive and increasingly de-regulated business. Any proposed incentives on users must not lead to financial disadvantages or an increase in charges, but in a decrease for best performers.

Imposing incentives on users is a double-hit on users who are already funding the system through their charges. If equipment projects have robust business cases and positive cost benefit analysis agreed with the users, then these should be mandated without any requirement for equipage incentives.

We note that the EC ANS Charging Regulation requires that any incentives on users should reduce the overall cost of services and increase their efficiency. Additionally we do not support price modulation or differentiation unless it can be seen to be cost-related and achieve a better use of airspace capacity.

In our experience peak or congestion charging for example has negligible impact or influence on traffic patterns and are largely ineffective in solving the problems
they are supposed to resolve. Any difference would have to be so high to influence behaviours that they would likely also generate claims of discriminatory or anti-competitive pricing. Airlines have little opportunity to adjust schedules to such incentives in an efficient way due to the complex task of scheduling operations.

With regard the London Approach charges and as previously mentioned our preference is for cost-related charges. Our understanding is that this, together with application of the MTOW formula, will eventually be required by January 2010 within the EC ANS Charging Directive rules.

On possible competitive and discriminatory grounds we believe any move to create a higher charge London TMA area should only be in concert with similar zones being created at other European major airports for a level playing field. Naturally we would expect any such changes to be at least revenue/cost-neutral.

Over the longer-term, including CP3, the impact of the London Olympics can be considered relatively small, and while any additional costs will of course be compensated by additional revenue it is unclear what the net effect will be. We therefore agree with the CAA’s view that it is unnecessary to limit the scope of the price control or any aspect of any incentive mechanism for the period of the Games.

Q.14 Do respondents have any other views on any scope issues raised in this chapter, or on questions of scope which have not been covered here?

We have been concerned with NATS perceived approach that any additional costs as a result of spectrum pricing proposals by Ofcom can be regarded as a “cost pass through” to the users.

We recall and fully support the CAA CP2 Formal Proposal that the CAA wished to make it clear that its intention is that NATS should have an incentive to minimize the costs that might arise from the arrangements being developed by Ofcom”, and that NATS should only be allowed to recover efficiently incurred costs that arise.

In our view the spectrum AIP pricing proposals are seriously flawed. While there is nothing to be gained to the UK economy or the aviation sector, we believe it would create an economic burden, competitive distortions, set precedents for other national activities in contradiction of international safety obligations and even create an environment where international repercussions could impact on UK aviation and its economy.

Q.15 The CAA invites views on its provisional assessment of the potential
interaction between UK economic regulation of NERL and the proposed SES II performance regime.

Q.16 The CAA invites views on its proposed approach to the scope and conduct of the CP3 review, which seeks to align as far as possible the outcome of the CP3 review with the requirements on the UK which are likely to stem from SES II.

We fully support the introduction of the Performance Framework with binding targets as the most important element within the proposed EC SES II package. In this regard, it must be considered that all of the other European ANSP are operating within the “full cost recovery” system that does not incentivise improved performance or cost-effectiveness. As a part-privatised and fully commercialised provider subject to independent economic regulation we would expect NATS performance and targets to be more challenging and robust.

Q.17 The CAA would therefore welcome views on the relative weight that should be attached to the two objectives set out above.

We agree that efficient financing should be one of the main objectives within the acceptable risk profile for the stakeholders at the same time as ensuring that the financial investment is sufficiently robust so as not to place investment, the operation of the business and service quality at undue risk.

Q.18 Do respondents agree that the two alternative approaches are as set out above; or are there any other approaches to the regulation of finance?

Q.19 Do respondents agree that the CAA should pro-actively regulate NERL’s financial arrangements via licence conditions?

In view the high risk and costs for users from any failure by NATS to provide their essential and monopoly service we would generally agree the CAA approach of regulation through License conditions.

Q.20 The CAA invites views on what, if any, changes should be made to the existing license regime.

Our understanding is that a number of additional License requirements, as detailed in 8.4, were added following the “Composite Solution” to ensure tighter financial control. We would expect full consultation on any proposals to change or dilute these requirements.

Q.21 Do respondents agree that CAPM should form the principal means of
estimating the cost of capital?

As during the recent BAA airports reviews, we agree that use of the capital asset pricing (CAPM) is the most appropriate model as the principle basis for setting allowed returns in the CP3 review.

Q.22 Do respondents agree that the approach to the market equity risk premium, analysis of beta and the non-zero debt beta provide will be relevant considerations in the CP3 review?

Q.23 Do respondents agree with the CAA’s initial thoughts on the cost of capital as set out above? What other factors should the CAA take into consideration?

We generally agree that the CAA approach to the market equity risk premium, analysis of beta and the non-zero debt beta will be a relevant consideration in the CP3 review, and with the CAA’s initial thoughts on the costs of capital. We realize there is considerable financial uncertainty at the moment as a result of the economic recession, but given that the review is looking at price caps from 2011 there will presumably be both upsides and downsides impacting the cost of capital.

Geneva 12 January 2009