CP3 Customer Consultation Working Group

Report from Co-Chairs

1 Introduction

Background

NERL and airline customers have completed the Customer Consultation process mandated by the CAA as the first part of process for setting NERL's price controls for the next five year price control period starting on 1 January 2011 (CP3).

Customer Consultation is intended to inform the second stage of the process during 2010, led by the CAA.

In March 2009, the CAA set out the terms of the mandate for Customer Consultation in its document "CP3 price control review for NERL – CAA Mandate for Customer Consultation".

Purpose

The purpose of this report to the CAA from the Co-chairs of the Customer Consultation Working Group (CCWG) is to:

- report on the conduct and effectiveness of the CCWG process;
- describe the modifications that NERL is making to its Baseline Business Plan, for submission to the CAA in December 2009, following the conclusion of the Customer Consultation process; and
- set out areas of consensus and areas where there is not consensus.

The paper sets out under each of the main consultation issues: a summary of the key elements of the Baseline Business Plan; NERL's proposed revisions; areas of consensus between NERL and customers; areas where there is not consensus; and the relevant CAA mandated consultation questions.

2 Consultation Process

2.1 PROCESS

Customer representation at CCWG

Invitations to join the Customer Consultation process were issued to all of NERL's airline, trade body and business aviation customer organisations in February 2009. Following this invitation, 44 Customer representatives from 27 organisations signed up to the process, representing the majority of movements through UK airspace and a comprehensive cross section of airline interests and trade associations.

Working Arrangements (code of practice)

The process was initiated at a kick-off meeting in March 2009 at which the CAA presented the context to the Customer Consultation process and the CAA mandate within which it operated. The meeting considered draft working arrangements (code of practice) and the draft content plan (meeting schedule and meeting agendas) which were presented for customer comment. Roger Wiltshire, Secretary General of BATA, was selected by customers to act as customer co-chair.

Working arrangements were updated based on customer comment and the meeting schedule, dates and agendas in the content plan were agreed within 10 working days of the kick-off meeting.

Working arrangements established key ground rules for the meetings and publication of material which were adhered to throughout the process. These included:

- Condition for quorum and chairing the meetings;
- No side meetings were to be held unless specifically authorised by co-chairs and communicated to the whole CCWG;
- Papers were to be published no later than 1 week prior to meetings;
- No new material was to be introduced at meetings without prior agreement;
- All CCWG meetings were to be transcribed by a stenographer, with transcripts made available to all CCWG named customer representatives;
- Minutes were to be published in draft within 3 working days of meeting, to record consensus, majority view, minority view and matters with no clear view. A 5 day comment period was to be allowed before final publication and all customer requests for changes to minutes were to be incorporated; and
- A dedicated web portal was to be provided for access to all papers and presentations.

Content Plan (meeting schedule and meeting agendas)

The meeting content plan was set out to enable a comprehensive and structured consultation around the content of the NERL baseline business plan through a series of six CCWG meetings, with specific agendas focused on answering the CAA mandated questions. This content plan was discussed and agreed at the kick-off meeting. In addition to the CCWG meetings, a number of sub-working group meetings to look in more detail at traffic forecasting, service quality/environmental metrics and the NERL CP3 capital investment plan. These meetings were added after the start of the Customer Consultation process and at the request of customer representatives.

Modification of process to meet customer requests

Prior to the CAA mid term meeting, customers raised concerns that there might not be sufficient time allocated to discussion of different service and cost scenarios and the CP3 capital investment plan. As a result it was agreed to extend CCWG5 into a two day meeting, to provide additional background information around scenarios and to hold a specific sub-group on the capital investment plan.

Customer Engagement

The customers involvement was excellent with good numbers of representatives from operational, commercial and regulatory backgrounds and a broad range of industry interests. Customers made requests for more information on a number of topics and responses were provided to questions which were tracked throughout the process and made available via the web portal. This additional data included a detailed response to customer questions related to different service and cost scenarios, as well as capital investment together with additional background material for the environment, service quality and traffic forecasting sub-group meetings. Following the capital investment and service quality/environmental metrics sub group meetings customers agreed a common response to the CCWG and these were presented at the subsequent CCWG meetings.

Customers also indicated their expectation that, in due course, there would be alignment between the process to establish NERL's price controls for the next 5 years and the performance scheme for all Member States of the EU following the adoption of the SES Package II.

Overall assessment of effectiveness of process

From the co-chairs' perspective, the Customer Consultation process adhered to the working arrangements and successfully addressed the CAA's mandated questions. Meetings generated good customer attendance and engagement. Customers have been well organised through pre-meetings with their nominated co-chair, Roger Wiltshire, building alignment around their approach to key issues. The CCWG minutes should provide the CAA with relevant input for the CP3 review concerning customer agreement, as well as majority and minority views.

3 Key Consultation Issues

3.1 TRAFFIC FORECAST

Key elements of NERL Baseline CP3 Business Plan

Chapter 4 of the Baseline Business Plan introduces NERL's traffic forecasts for CP3, and sets out this forecast, which was finalised in January 2009. Appendix 2 of the Plan sets out more detail on the CP3 forecast, including a breakdown of forecast chargeable flights, distances and CSUs.

The traffic forecast also underpins other areas of the NERL Baseline Business Plan, namely Chapter 7 (Service plan), Chapter 9 (Investment plan), Chapter 10 (People and engagement) and is built into the indicative price profiles set out in Chapter 13.

The January 2009 traffic forecast showed year on year reductions for 2009 flight volumes, chargeable distances and CSUs of 6.1%, 6.2% and 6.1% respectively. The forecast predicted a gradual return to growth in 2010 of 1.2%, 1.7% and 2.3% respectively. Oceanic flights were forecast to reduce by 3.7% in 2009/10 on 2008/09 levels. Thereafter, Oceanic traffic was expected to increase by 3.2% in 2010/11.

Over the CP3 period (end 2010 to end 2015) forecast flights, distances and CSUs were predicted to increase by 18.1%, 19.5% and 21.9% respectively. Oceanic flights were expected to grow by 19.7% over the same period.

NERL's proposed revisions to the Baseline Plan

The traffic forecast produced by NERL in January 2009 informed the Baseline Business Plan. This forecast was produced at the beginning of an unprecedented economic downturn, with traffic levels falling significantly beyond what was envisaged.

A new forecast was developed by NERL in September 2009 using more up to date economic data and revised modelling assumptions. This new forecast has been informed by discussions between NERL and customers during the CCWG process.

Key revisions to the September forecast from the January forecast include:

- lower GDP forecast (the biggest influence on traffic) between December 2008 and August 2009;
- clarity that mixed mode at Heathrow would now no longer be available (this was confirmed in January). As a result, it looked likely that, whilst airlines could accommodate some growth through increased load factors and increasing aircraft size, Heathrow would only accommodate increased traffic growth when a new runway was introduced;
- a more developed model on the impact of the introduction of the Emissions Trading Scheme with much more up to date information on air fares and on elasticity;
- clarity that the increases in air passenger duty would be levied per passenger rather than per aircraft which would impact the long haul market to a large extent;
- air fare information and elasticities from IATA;
- the addition of 1000 business jet flights on top of the 4000 estimated commercial flights during the Olympics in 2012 following discussions informed by experience from other Olympic events;
- a shift down in the trend growth of cargo and overflights;
- a revision in business jet forecast based on 8 months of actual data projected forward against GDP
- reduced load factors in the short term as passenger demand was falling faster than airlines were cutting capacity and finally
- deferment of orders by airlines (rather than cancellations).

The September 2009 forecast shows year on year reductions for 2009 flight volumes, chargeable distances and CSUs of 8.2%, 9.4% and 8.5% respectively. The forecast shows a gradual return to growth in 2010, with flights, chargeable distances and CSUs increasing by 1.8%, 2.0% and 1.5% respectively on 2009 levels.

Over the CP3 period as a whole (end 2010 to end 2015), the September forecast shows growth of 17.2%, 17.2% and 17.3% for UK en route flights, chargeable distances and CSUs, respectively. Oceanic flights are forecast to increase by 10.6% over the same period.

The September 2009 forecast represents a lower baseline than the January 2009 forecast for the CP3 period. The key factor driving the lower baseline of the CP3 forecast is the downward revision of GDP.

NERL intends to use the September traffic forecast to inform the Business Plan for CP3. If the traffic outlook changes materially, a further updated forecast will be built into an updated Business Plan in March 2010, which the CAA has requested.

Areas of consensus between NERL and Customers

At CCWG2 NERL shared its forecasting methodology with customers. NERL also presented the key drivers of the January traffic forecast, and these were discussed with customers at a subsequent sub group meeting. It was agreed that a more up to date forecast was required to inform the December Business Plan. Following this meeting NERL revised some of its modelling assumptions, using up to date information on fare prices and passenger elasticities to create more robust modelling assumptions.

Customers were given a further opportunity to interrogate the modelling assumptions during the second meeting of CCWG5. NERL believes that, as a result of these discussions and its revisions to its forecasting methodology, there are no major areas of disagreement

Areas where there is not consensus

At CCWG 6 the question arose as to whether NERL was incentivised to deliver a forecast which understated traffic so as to gain a better regulatory deal. NERL countered that it is in their best interest to achieve as accurate a forecast as possible to ensure that sufficient capacity could be provided to handle forecast traffic levels. The current regulatory formula has built in incentives to encourage accurate forecasting. NERL also stated that the traffic forecast can only be as good as the information available, including airline information on future schedules.

Relevant CAA mandated consultation questions

Two of the CAA's mandated questions relate to NERL's traffic forecasts:

- What is the appropriate traffic forecast (high, low and base cases), on a calendar year annual basis, between 2011 and 2015 for:
  a) UK En Route CSUs?
  b) UK En Route chargeable distances?
  c) Oceanic En Route flights?

And:

- What are the patterns of traffic and shifts in these patterns projected between 2011 and 2015, and what implications might these have for NERL's delivery of capacity and service levels?

At CCWG2 NERL set out its forecasting methodology, outlined the importance of producing an accurate forecast and discussed the key forecasting drivers. These drivers were interrogated by customers at a subsequent sub group meeting in July.

At CCWG5 in September NERL presented a draft traffic forecast which contained revised (July) GDP information and a few main forecasting drivers[1]. NERL also produced a breakdown of the traffic forecast by UK market[2] over the CP3 period so as to show expected traffic flows. During day 2 of CCWG5 a one hour Q&A session was held on NERL's forecasting methodology.

Finally, at CCWG6 in October. NERL presented its September traffic forecast for information only. A paper was released in advance setting out the forecasting results and providing more information on how the forecast had changed since the initial forecast was produced in January, including an overview of how the customer consultation process had informed the modelling work.

A paper was sent to customers in advance of each meeting providing more detailed information supporting the presentations given at the Customer consultation meeting.

The forecast information provided addresses both of the CAA's mandated questions, additional forecast data was provided on UK en route flights.

As the traffic forecast underpins many elements of the consultation process, the latter part of the second question was incorporated into other CCWG discussions, in particular during the CCWG 5 session on trade off scenarios.

[1] Airport capacity, ETS, APD, cargo.
[2] Transatlantic arrivals/departures, transatlantic overflights, other arrivals/departures, other overflights and domestic flights.

3.2 SAFETY PLAN

Key elements of NERL Baseline CP3 Business Plan

NERL's Draft Baseline Business Plan includes a specific safety programme (the strategic plan for safety), designed to deliver a significant reduction in the likelihood of a collision involving aircraft receiving a NERL service, with a particular emphasis on reducing the Significant Event (SSE) risk index in the London Terminal Control (LTC) operation.

The ongoing programme of technical investment, and the continuous development of airspace and procedure design in response to changing traffic patterns, requires continual change. The Baseline Plan contains actions and resources to meet the safety risks associated with this level of change.

The plan includes targets to maintain and improve safety, specifically a target of zero Category A&B airprox attributable to NERL and a target to reduce the annual Safety Significant Event (SSE) risk index by 20% per year until March 2011 and then by 10% per year through to the end of CP3.

NERL's proposed revisions to the Baseline Plan

Following the Customer Consultation process, NERL is not proposing any revisions to its Baseline Plan with respect to safety. It proposes to implement its safety programme and to pursue the safety targets set in the Baseline Business Plan

Areas of consensus between NERL and Customers

Customers have confirmed that safety is the paramount consideration. They are generally supportive for the strategic plan for safety and, in particular, for targeting safety hotspots.

Areas where there is not consensus

Some customers questioned whether the safety improvement target of 10% needed to be so challenging and also whether General Aviation was making a sufficient contribution to the cost of safety improvement (in particular infringements). The latter point has been noted in the minutes as relevant for review by the CAA as part of its process.

NERL's position regarding the level of safety target is that its experience of implementing the strategic plan for safety had changed its philosophy from maintaining safety levels whilst traffic grew to seeking continuous improvement driven by the better appreciation and treatment of risk from leading indicators. The 10% year on year improvement is achieved by a combination of maintaining safety across the operation, whilst dealing specifically with the highest risks where they arise.

Relevant CAA mandated consultation questions

The key question covering safety mandated by the CAA is "What is the customer requirement for safety, both during CP3 and beyond?" This question has been addressed through the content of the consultation papers and in particular through discussion and CCWG meetings 4 and 5.

3.3 SERVICE QUALITY

Key elements of NERL Baseline CP3 Business Plan

NERL's draft Baseline Business Plan includes proposals on service quality which feature a headline target of average delay per flight of below 25 seconds, supplemented by two further measures - covering an index of total delay impact on customers, and an index of variability / consistency of daily average delays. Targets for the two further measures were to be consulted upon during the formal consultation process.

In addition, the Baseline Business Plan includes a proposal for a contingency capability to handle 85% of traffic within 10 days of the loss of a Centre.

NERL's proposed revisions to the Baseline Plan

For delay performance, NERL is of the opinion that the three terms proposed initially at CCWG3 and subsequently revised through CCWG3 sub-group and CCWG5 form an appropriate basis for delay performance incentivisation:

NERL set out proposals for three Delay terms at CCWG3 as follows:

- T1 – Average Delay – expressed as the "Average Delay per Flight"
- T2 – Impact of Individual Delays – expressed as an "Impact Score" based on the sum of weighted delays divided by the total number of NERL-chargeable flights
- T3 – Variability of Daily Average Delays – expressed as a "Daily Excess Delay Score" based on weighted delays exceeding pre-determined thresholds on a daily basis
- NERL also proposed concepts of par value range, par value modulation with traffic & T1 par value profile where T1 par value would be tighter at the start of the control period.

NERL provided examples of par values for illustration purposes and has committed to provide proposed target values for the March 2010 business plan when traffic forecasts have been confirmed. This target values would be linked to assumed levels of investment and operating resources.

Areas of consensus between NERL and Customers

At CCWG5 customers stated that they agreed in principle with the definition of T1 and T3 and with the concepts of par value range, par value modulation with traffic and profiling of T1 to make the target tighter at the start of CP3.

Customers proposed revisions to T2 weighting to remove "zero weighting" of delays less than 15 minutes outside peak periods and the NERL proposal has been updated to reflect this request.

Customers did not challenge the proposed target of capacity to handle 85% of traffic with contingency facilities which has previously been consulted upon in SIP 2009.

Customers placed a clear emphasis on rigorous and demanding service measures ahead of reductions in front line operating costs, if presented solely with this choice.

Areas where there is not consensus

For T2, NERL is proposing an Impact Score based on weighted delays divided by the count of all NERL controlled flights. Customers proposed an alternative definition based on a denominator of "Delayed Flights" and a separate term based on "% Flights Regulated". NERL has investigated these options and does not support them because of the inappropriate behaviours they could incentivise given that both the numerator and denominator can be modulated by NERL ops room behaviour. NERL believe that each term should work in isolation and therefore does not support the concept of having a delay per delayed flight term plus a separate % of flights delayed term. NERL supports combining these two terms into a single term which has the same mathematical result.

Customers have proposed an additional delay term (T4), defined as the average delay per flight subject to ATFM regulation. When asked why an additional term is requested, customers advised that they wanted a term which is not diluted by out of area traffic that is not subject to ATFM. NERL would be neutral to the use of T4 alongside the other three metrics, although NERL does not consider that it adds any value beyond T1 and T2. This is because it follows a very similar profile to T1 and performance during the period of peak out of area demand is incentivised by T2.

Customers requested inclusion of Minimum Departure Intervals (MDIs) into the performance regime. NERL supports the principle of including delays caused by MDIs, but is unable to support their inclusion until individual flight impacts can be captured and robust causal factors (weather or capacity, etc.) can be recorded. NERL anticipates that the introduction of Departure Manager systems (DMAN) during CP3 would enable improved reporting at those airfields where it is installed, hence it could be possible to include MDI delays at these airfields in a CP4 regime. In the interim, NERL has committed to improving reporting on MDI usage and would welcome discussion with customers on development of metrics for use with the Operational Partnership Agreement and as internal measures.

Whilst customers may be willing to accept some accommodation for the Olympics in 2012 this should not be regarded as a relaxation of all performance targets during 2012 or during the period of the Olympic Games.

Customers proposed that bonus should be modulated with traffic and that the full bonus amount should only be payable if all targets are met. NERL considers that the issue of strength and balance of incentives will also be covered by the CAA's consultation during 2010. As a point of principle, NERL believes that incentives should continue to offer scope for NERL to earn positive and negative incentives

Relevant CAA mandated consultation questions

What is the customer response to NERL's Business Plan, in the areas of Service delivery?

What is the customer requirement for service delivery priorities during CP3 in relation to operational contingency?

What is the customer requirement for service delivery priorities during CP3 in relation to service quality?

What is the customer requirement for service performance measures and par values for CP3 metrics?

3.4 FLIGHT EFFICIENCY AND ENVIRONMENT

Key elements of NERL Baseline CP3 Business Plan

Consistent with its commitment to responsible environmental management, NERL's draft Baseline Business Plan includes proposals to improve flight efficiency and to reduce environmental impact. The plan contains the target to improve flight efficiency to enable an average 10% per flight reduction in ATM CO2 emissions by

2020 from a 2006 baseline, with the objective of developing a metric to track horizontal and vertical flight efficiencies.

NERL's proposed revisions to the Baseline Plan

NERL is devoting significant resource to this matter and aims to be in a position to confirm by March 2010, whether the deployment of an incentivised metric is feasible. Even then, it is NERL's expectation that knowledge about a stable metric for incentivisation may not be achievable before the start of CP3. In this event, NERL has proposed a road map for the introduction of such a metric.

Areas of consensus between NERL and Customers

Customers support NATS' proposed action plan to reduce CO2 emissions and to improve fuel efficiency. Customers agreed that the payback associated with environmental/fuel efficiency investments are such that they would be supported but they requested that NATS provide more detail as soon as it is available.

The group agree with the principles governing the metrics NATS has proposed

Customers agree that the five candidate metrics appear to be the right ones and should be left on the table during the consultation process to enable further evaluation of the results; identification of any unintended consequences, and refinement as necessary.

Customers agree with the principle of the roadmap approach.

With respect to an incentivised metric, customers advise that it was not the quantum of any financial incentive that was important, but rather the principle of a financial incentive existing to encourage the right behaviours.

Areas where there is not consensus

The customers' requirement is for the introduction of CO2/environmental metrics from the beginning of CP3 – at the very least introduction of the basic metrics from day one. Customers contend that they have been heavily involved in preparing CO2 emission plans for the introduction of emissions trading, and that NATS should be subject to the same timescales.

NERL states that it has been working hard to develop broader environmental metrics as well as an appropriate CP3 financially incentivised metric. To date, analysts are dissatisfied with the metrics that are available. Only the Eurocontrol Route Extension measure has a data track record and NERL considers this measure to be potentially ineffective in driving fuel burn and CO2 improvements. As such, NERL believes its use could even have unintended adverse consequences if adopted as a CP3 financially incentivised metric. For example, if route reductions are improved at the expense of vertical profiles.

It should be noted that if a metric can be developed there would be very limited time to test its performance before the start of CP3. As a result, NERL considers that the financial exposure should be limited by the risks inherent within a relatively unproven metric (i.e. weakly financially incentivised).

Relevant CAA mandated consultation questions

What is the customer requirement for fuel efficiency performance and NERL's wider environmental performance?

3.5 ADDITONAL SERVICES

Key elements of NERL Baseline CP3 Business Plan

NERL's draft Baseline Business Plan includes proposals for additional services introduced during CP2:

- Extended Farnborough-London lower area radar service (LARS) to address the safety risk caused by infringements of London TMA airspace;
- Sudden loss and mitigation (SLAM) to provide contingency for ongoing service in the event of a catastrophic loss of service from one of NERL's Centres;
- The use of SLAM to provide some additional ATC services outside controlled airspace (ATSOCAS); and
- Aviation charting and data service – becoming one of NERL's specified services within the price control, rather part of the CAA's functions / charges.

NERL's proposed revisions to the Baseline Plan

These additional services were already included and costed in the Baseline Plan and NERL is proposing to retain them in the revised plan.

Areas of consensus between NERL and Customers

There was general customer support for those additional services introduced during CP2 to be continued into CP3.

Areas where there is not consensus

Customers questioned whether General Aviation was making a sufficient contribution to the cost of these additional services. This has been noted in the minutes as an issue for review by the CAA as part of its process.

Relevant CAA mandated consultation questions

The questions relating to this area mandated by the CAA are:

- What is the customer requirement for service delivery priorities during CP3
  a. Service quality?
  b. Operational contingency?
- What are the customer priorities, where options exist in the areas of service, future service delivery, given cost trade offs (e.g. service requirement versus cost)?

3.6 INVESTMENT PLAN

Key elements of NERL Baseline CP3 Business Plan

NERL set out the key elements of its proposed investment plan in section 9 of the baseline Investment Plan, recognising that a key customer requirement is to strike an appropriate balance between the short-term pressure to reduce capital expenditure (and hence unit rates) and the longer-term service delivery goals. The draft business plan highlighted that, whereas CP2 investments had a focus on centre consolidation, the emphasis in CP3 is on the consolidation and convergence of systems within the centres together with the introduction of electronic tools to establish the foundations for SESAR trajectory-based operations in CP4.

The draft baseline business plan identified a baseline capital investment programme of £682m (out turn) covering a balanced and highly integrated portfolio of projects to improve safety, reduce operating costs, increase capacity to match demand and to provide environmental benefits whilst ensuring that service obligations are met by sustaining systems and replacing end-of-life assets.

This proposed investment level of £682m (outturn) is c. 11% lower in real terms than the CP2 investment plan. The plan also provided a commitment to allow 10% flexibility in re-prioritising projects via the Service and Investment Plan process throughout CP3 if customer priorities changed.

Investment is a key enabler of improving efficiency both in 'fixed' and 'variable' cost areas – deferment of projects would therefore impair NERL's ability to drive efficiency improvements in the future

NERL's proposed revisions to the Baseline Plan

Customers expressed strong views on the proposed investment plan presented at CCWG4 In particular, customers requested a lower level of investment in response to lower forecast traffic, further cost optimisation by the removal of the flexibility in the plan, and the deferment of any non-essential sustainment to reduce the overall cost. In response to lower forecast traffic and to customers' views, NERL proposed a revised base investment plan at CCWG5 which took account of the customer requests. The resulting revisions created a cost-optimised plan costing £650m (out turn) that maintains service quality and maintains the focus on the safety improvement hot spots, and defers a number of programmes and projects to reduce the capital cost in CP3.

The revised investment plan has a higher level of residual risk than was contemplated in the baseline business plan, in particular the removal of the flexibility in the plan limits the ability to respond to any specific needs emerging from OPA and SIP consultation, e.g. related to FAB developments. NERL is reluctant to make any further cost reductions because in its view the resulting risk would become unmanageable.

At CCWG5, customers also requested more information to understand in greater detail the content and characteristics for the investment plan in order to satisfy themselves about its size and rationale.

Areas of consensus between NERL and Customers

The revised plan was discussed in detail by a sub-group of CCWG5 on 13th October 09, looking at the content and cost of the 36 Programmes areas and c.200 constituents projects; the type and level of benefits they were expected to deliver; and the amount of risk & contingency funds allocated. Customers accepted that the material set out the rationale for the proposed plan and acknowledged that it presented a complex and highly integrated portfolio of investments, with changes to one aspect highly likely to have consequential impact on other areas.

The customers concluded that they agree that the revised base case (£650m) plan is the right set of investments. Customers also highlighted that it would be a challenge to deliver the programme within the timescale given the risk of slippage to SESAR and Industrial Relations implications. NERL agreed that delivering the proposed plan will be challenging as it in part seeks to develop and deliver innovative and complex software applications hosted on safety-related systems.

Areas where there is not consensus

Whilst the customers concluded, at the sub-group on 13th October that they agree the base case (£650m) plan is the right one, they challenged that it should be deliverable for the low case numbers (£620m). In particular customers questioned the level of risk and contingency in the plan and whether, as a result, there is room for a further cost efficiency programme within the SIP. There was also some challenge on the IS investment of c.£30m.

Customers highlighted a number of cost areas where they would request further clarification from the regulator on the handling of commercial airline customer cost allocation, including :

- NERL licence requirement for Primary Radar as customers believe there is no Civil requirement. The customers identified that the same is true for Multistatic Radar & that they would like to see progress on cheaper surveillance technology e.g. ADS-B.
- Safety investments to reduce the impact of General Aviation intrusion into controlled airspace.
- Nav-aid rationalisation as the need for retention seems to be driven by General Aviation needs.
- Other facilities and services required by the NERL license where there may be cross-subsidy between commercial and general aviation users or activities associated with Space Based Augmentation systems where there was no stated requirement from airlines.

Relevant CAA mandated consultation questions

The following three CAA mandated questions have been fully covered during the investment plan element of the customer consultations with the areas of consensus and areas where there is not full consensus, described above:

- What is the appropriate NERL programme delivery capability during CP3?
- What is the customer response to NERL's base case and high case long term investment plan, given the capex financial envelope trade off?
- What is the customer response to NERL's proposal for risk and contingency built into the capital investment financial envelope for CP3?

3.7 OPERATING COST EFFICIENCY

Key elements of NERL Baseline CP3 Business Plan

NERL's Baseline Business Plan builds in operating cost efficiencies, enabled by a major cost saving programme to achieve a £45m (c. 15%) real reduction in the previously planned operating cost base by the end of CP2 – amounting to a cumulative saving of £225m in CP3 (at current prices). This is followed by a further cumulative reduction in CP3 of around £100m (at current prices) in real unit operating expenditure (RUOE) to achieve a 2% p.a. target reduction. These savings are planned to be achieved mainly through a 27% reduction in non-controller staff – 22% in CP2 and the remaining 5% during CP3. A number of major programmes remain to be delivered to secure some of these savings and so a major risk in the plan is being able to reduce headcount to achieve the target. NERL's pension reforms would also avoid c£200m of cost in CP3. All told, the savings would avoid cost of over £500m in CP3.

These efficiency savings follow on NERL's drive to improve its efficiency in CP1 and CP2 through: centre closures (two out of four); consolidation of property estate; restructuring of business areas; improvement of productivity of front line operations; improved quality and output of ATCO training; modernised terms and conditions; pension reforms; more stringent pay deals and cost optimisation programme.

The efficiencies in NERL's Baseline Plan are influenced by the structure of NERL's operating costs. Approximately 1/3 of NERL's operating cost base is related directly to operational staff at the Centres, and therefore could be considered as variable, or volume related, and around 2/3 is essentially 'fixed' (non-volume related) in the short to medium term, and is mainly influenced by levels of investment.

The 'fixed costs' comprise mostly asset related costs – the engineering and facilities management costs of operating and maintaining the operational infrastructure – plus corporate and support services, such as the training & simulation function. These functions are staffed principally by non-controllers, for which staff numbers are already projected in the Baseline Plan to decrease significantly, by c. 27% by the end of CP3.

The volume related costs comprise mainly operational controllers (ATCOs) and operational support staff (ATSAs). In this area, ATSA numbers are already planned to reduce by 33% as a result of the introduction of new technology which will automate a significant element of the ATSA task.

An imperative in NERL's current drive to reduce underlying operating costs by £45m relative to the amount previously planned has been to be very sensitive with operational front line resources, because of the direct impact that changes in this area can have on customer service.

NERL's proposed revisions to the Baseline Plan

In response to Customers' views, NERL has proposed reductions in the size of its previously planned capital investment and the revenue costs associated with this. NERL is also considering whether it is able to make any further volume related cost reductions associated with the lower traffic forecast (in comparison to the forecast in the Baseline Plan), without impairing service quality, which customers have no desire to see.

In reaching a conclusion, which will be reflected in its revised Plan, NERL's view will be balanced and informed by a) the imperative to continue delivering good quality service to customers; b) NERL's view that any benefit of cost savings from further reductions in front line operating costs would be far outweighed by the additional delay cost incurred by customers; c) the risk exists of traffic recovery exceeding the base case forecast; and d) relatively long lead times in reinstating capacity.

Subject to this final review, NERL currently expects to maintain efficiency savings at levels planned in the Baseline Business Plan.

Areas of consensus between NERL and Customers

Customers have not questioned the basis of NERL's planned efficiencies and recognise the efforts NERL has made to improve efficiency, through its strategy of rationalising the number of control centres, the programme to reduce operating costs by £45m, and the pensions reform that has avoided £200m of costs in CP3.

Areas where there is not consensus

Through the consultation process, customers have challenged;

- whether the Business Plan is 'balanced' and whether further cost savings are not possible without any impact on the outputs of the business and
- whether the current downturn provides NERL with an opportunity to achieve greater efficiency savings from the changes achieved in CP2 and
- that all the fat had been removed from NERL's cost base and do not accept the business plan as a baseline from which trade-offs could be discussed and

- the credibility of the planned cost savings over CP3 and do not believe that NERL's planned 2% pa reduction in underlying operating costs to be sufficient in current economic climate and compared to their own efforts and
- the CAA efficiency studies as they are mainly comparisons with other ANSPs and not true benchmarking and
- the effectiveness of NERL front-line rosters in meeting the workload efficiently

NERL's position is that the company's efficiency should be assessed taking into account the progress made in CP1 and in CP2 and the whole of CP3, and not just CP3 in isolation. NERL's £45m cost saving programme over the last 2 years of CP2 has responded proactively to market conditions, whilst the efficiency target over CP3 recognises the need to service recovering traffic volumes over that period. NERL believes the level of operating costs in its plan is efficient, a position NERL believes is supported by the studies of the efficiency consultants appointed by the CAA during 2009, and that further reductions are likely to impair the level of customer service. NERL's ability to respond to short term reductions in traffic is constrained by the twice daily traffic peaks which remain largely unchanged, and by the regulations applying to ATCO working time.

Relevant CAA mandated consultation questions

The CAA mandated question relevant to this area relates to customer priorities for trading off service versus cost and has been addressed during Customer Consultation:

- What are the customer priorities, where options exist in the areas of service, future service delivery, given cost trade offs (e.g. service requirement versus cost)?

4 CONCLUSION

As the co-chairs of the Customer Consultation Working Group, we believe that the mandate from the CAA has been met.

We would like to acknowledge the work of both NERL and Customers to create and maintain a high quality discussion around complex issues which were of key interest to customers.

We also recognise the increased understanding which resulted in a high level of consensus in some difficult areas and subsequent changes made by NERL to the Draft Business Plan for CP3 for customer feedback.

In recording areas where there was no consensus, we have attempted to describe the nature of the positions and their rationale.

Our hope is that this report will now act as a useful focus for the CAA-led part of the review due in 2010.