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27th January 2010

NERL CP3 Review - Joint airline trade association letter to CAA

Dear Harry,

BARUK, BATA and IATA represent the vast majority of the airlines with operations controlled by NATS. Many of our member airlines were active participants in the recent Customer Consultation Working Group (CCWG) meetings organised by NATS. The CCWG process prompted useful debate on the NERL Business Plan (BP) for the third control period (CP3) from 2011 to 2015 but it proved inconclusive on many key issues. In particular, NERL and its customers could not agree on an appropriate baseline level of operational cost efficiency for CP3 and airlines were unable to agree the capital investment plan proposed by NERL.

The purpose of this joint letter is to inform you of our strategic concerns and to provide you with an airline input in advance of your first CP3 consultation paper which is expected in February 2010.

As a result of the recession, the airline industry is currently experiencing very difficult economic conditions. Individual companies are scrutinising all areas of cost and they are making difficult decisions in response to the very challenging market they face. In these circumstances, it is regrettable that a monopoly supplier to the industry is allowed to raise its prices with impunity. The recent decision by NATS in setting the unit rate for 2010 has demonstrated to our members that the current regulatory regime encourages the monopoly supplier to make “windfall gains” from the recession whilst, at the same time, undermining the recovery of the very market on which its customers depend.

In the context of this current market and our experience with the CCWG process we would like to raise the following strategic concerns;

1. Cost efficiency

The discussions at CCWG meetings were unable to reach the levels of detail necessary for airlines to understand how efficient NERL's operational or non-operational costs could or should be in CP3. Many detailed questions were deflected with reference to the studies being commissioned by CAA. Examples of the areas questioned by airlines include the efficiency of night-time operations and the extent of collaborative working with neighbouring ANSPs.

The comparative efficiency studies published by CAA to date are, in effect, comparisons with an historic industry average. They do not identify a true "benchmark" which NERL should strive to achieve and give us little evidence of NATS efficiency potential either today or during CP3.

We would expect the CAA consultation process in 2010 to address this fundamental weakness and provide answers to our basic questions on NERL's back-office and frontline efficiency.

2. Capital investment

The CCWG process provided airlines with further information on NATS Capital Expenditure Plan for the CP3 period. The airlines were surprised by the seeming lack of cost benefits to support several investment projects. The highly integrated nature of the investment plan often made it impossible to disaggregate a complex series of related projects such that priorities or weaknesses could be identified.

However, there is one aspect of the plan which we would like CAA to identify for special treatment in CP3. Many of the CAPEX projects are linked to the EU SESAR programme but the contractual nature of their contribution to SESAR is unclear. For airlines who fund NERL, and will continue to provide a return for NERL's future asset base, this begs a number of questions:-

- a) What extra costs are being incurred by NERL in order to meet joint venture or SESAR requirements?
- b) How will NERL customers benefit if/when systems developed during CP3 are sold on or used by other ANSPs across Europe?
- c) How can we be sure that NERL's customers are paying an appropriate share in any joint venture NERL has with other ANSPs?
- d) How can we be sure that NERL's customers are paying an appropriate share of investment costs in SESAR systems?

- e) What compensation will NERL customers receive if projects designed to meet European requirements fail to deliver or are replaced by solutions developed elsewhere?

We would ask you to ensure that these questions are addressed in your consultations so that airlines can get a clearer understanding of what they are paying for.

3. Incentive structures

There have been a number of constructive discussions between airlines and NERL on the subject of CP3 Delay Metrics and the detailed position has been reported in the minutes of the CCWG meetings. This recent development of more sophisticated measurements and delay incentive structures has followed a long period of steadily improving delay performance by NATS. It is the right time to introduce more sophisticated measures but, when setting incentives, it must be recognised that NERL has just entered the first prolonged period of capacity headroom in the history of NATS. This surplus of capacity is expected to remain until very late in CP3 or longer if the economic recovery is slower than currently forecast.

This capacity reality should be a significant factor in deciding the incentive regime for CP3.

CAA should also recognise NERL's regular out-performance of the incentive structure and we would ask for a fundamental review of the appropriateness of the bonus element in the structure.

4. Environmental efficiency

Appropriate and timely introduction of an Environmental Efficiency metric was the subject of much debate at the CCWG meetings. Airlines appreciate the work that NATS is doing both to quantify inefficiencies and find ways to minimise them. However, airlines also face the reality of inclusion in the EU Emissions Trading Scheme in 2012 and they expect this fact to be reflected in the CP3 regulatory settlement. We accept that more work is needed before the best metric can be identified but we also expect CAA to find ways in which such a metric can be introduced in time for 2012.

5. Convergence with SES II and the European Performance Scheme objectives

One of the most important aspects of NERL regulation over the next 5 to 10 years will be how the outcomes of UK regulation converge with the EU Single European Sky programme (SES II) and comply with its objectives.

In particular, we would expect the CP3 settlement to provide a trajectory which is consistent with SES 2020 objectives for ANSP unit rates, effective collaboration between ANSPs and the removal of the cost-plus approach.

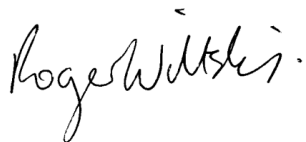
We would expect your initial consultation paper in February to explain how the UK process will dovetail with the SES process and ensure that the UK makes its full contribution to SES objectives.

6. Risk Sharing

The existing 50/50 risk sharing arrangement was introduced at a time when very special circumstances posed a clear financial threat to a very new and immature regulated company. NERL is now financially robust and their airline customers believe it is now time for a return to the usual regulatory practice, with NERL carrying 100% of the traffic risk.

Finally, we look forward to the first consultation and would be happy to arrange a representative delegation of our members to meet you or your team if you would like to discuss our concerns in more detail.

Yours sincerely,

A handwritten signature in black ink that reads "Roger Wilkie". The signature is written in a cursive style with a prominent flourish at the end.

On behalf of BARUK, BATA and IATA