Response to the CAA on
The NATS Price Control Review
CAA's Initial Proposals

28 February 2005

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Executive Summary

British Airways welcomes the opportunity to respond to the CAA's Initial Proposals consultation of the National Air Traffic Services (NATS) Price Control Review for the CP2 – the second control period 2006 - 2011. It is evident the CAA has devoted considerable effort to exploring the issues which inform the regulatory settlement and we welcome this. NATS has made a great deal of progress since the PPP in 2001 and we believe the system of economic regulation has played a key part in this. We believe the CAA's initial proposals are a move in the right direction, which recognise the further potential for NATS to find cost efficiencies, increase capacity and improve service quality to the benefit of all consumers in the course of CP2.

We welcome the CAA's intention to keep the maintenance of safety a primary consideration and that the CAA has liaised with the Safety Regulation Group to ensure that nothing in the proposals jeopardise, or might be expected to jeopardise, safety.

Airlines have invested much energy in reducing costs and re-structuring to address the challenges of the current economic and business climate. Monopolies with high demand for their services are much more insulated from the disciplines of market forces than other businesses. Therefore the CAA has a responsibility, as the NATS' regulator, to establish a regulatory settlement which incentivises NATS to deliver efficiencies and improved levels of service while ensuring necessary investment in new technology and capacity can still take place.

Since the Terminal Approach Service is a "core service" under the Licence its inclusion in the scope of regulation is a positive development. But any increase in the Terminal Approach charges to bring them into line with costs would need to be off-set by an equivalent reduction in En-Route charges. Since there are contractual arrangements in place at the moment for Terminal Approach services it will be important for the CAA to set out a transparent process for the rebalancing of these charges.

We see logic in applying a cost based approach to setting the regulated charges that does not subsidise the unregulated aspects of NERL's activities. But it is difficult to come to a definitive view without more information on the feasibility and robustness of NATS' cost allocation methodology. The KPMG study into this for the CAA raises concerns about NATS' process and the lack of meaningful output. Commercial airlines should not be exposed to the risk of subsidising the costs of NATS service to the MOD or North Sea Helicopters and we look to the CAA to ensure that revenues from these users cover the full costs of NATS in providing the a service to them.

The 50% fixed and 50% volume based revenue approach reduces the risk borne by NATS and this should be reflected in the cost of capital. We welcome the CAA's recognition that weight has no correlation with the costs NERL incurs to service flights but do not see a charging mechanism that allows under/over recoveries to be adjusted over several years as being in users' interests.

We broadly agree with the CAA's proposed assumptions for traffic volume growth during CP2 and support most of the suggested adjustments to NATS' own projections.
We welcome the CAA's proposals to strengthen the delay term as a means of increasing the emphasis on service quality. The financial effects of the delay term in the current control period have not been significant but the regulatory signals have influenced NATS' attitude and approach to delay. This has been helpful given change takes time to achieve. Of the two options proposed by the CAA, we support Option B. We agree that early morning delays and

long delays have knock on consequences and that this change to the form of the control would help create the best incentives.

Operating expenditure accounts for approximately 70% of NATS' costs and it has the biggest influence on the revenue requirements and price cap. Therefore it is very important for the CAA to establish meaningful incentives that will drive efficiencies into their business. We believe the CAA's proposed targets for efficiency improvement are achievable and that sufficient scope exists for more efficient procurement, productivity improvement and support staff savings to ensure they can be delivered without compromising operational effectiveness.

Given the underinvestment of capex by NATS in CP1 we welcome the intention of the CAA to incentivise investment delivery at an efficient cost. We believe that a robust output based framework that links charges to delivered investments should be established in the regulatory settlement. We propose a model that replicates the process of procuring software projects from a competitive supply base in which stage payments are made in line with the achievement of an agreed delivery schedule. Such a model would provide NATS the funding required to invest whilst protecting users from a situation of paying for investment which has not been delivered – for whatever reason.

As we indicated in our previous submissions, we agree with the CAA's decision to employ the Capital Asset Pricing Model (CAPM) as the basis for setting the regulatory cost of capital. We also agree with the CAA's proposed adoption of a pre-tax real approach, in line with general convention and most regulatory precedent. We have reviewed our assumptions in the light of the analysis and evidence presented in the CAA's initial proposals, and in the accompanying report prepared by Price Waterhouse Coopers (PWC). As a result, we have raised our estimate of the appropriate cost of capital for NERLs' UK air traffic services business to 5-5.5%. This is still considerably lower than the CAA's proposal, which we believe is unreasonably high, and does not adequately reflect the reduced risk that NATS is exposed to following adoption of the Composite Resolution in 2003.

We agree with the CAA's proposals for the design of the Oceanic price control but highlight the areas of those dimensions of the price cap where we consider the CAA in determining the regulatory settlement should adopt alternative parameters.

Overall the CAA should ensure that the regulatory settlement is one which meets its statutory duties and which furthers the public interest by incentivising NATS to deliver cost efficiencies, improved levels of service and an efficient and effective investment programme.

1.0 Introduction

1.1 This submission sets out the position of British Airways (BA) in response to the CAA's Initial Proposals for the regulatory settlement NATS Price Control Review for the second regulatory period CP2. It is evident from the proposals that the CAA has devoted significant effort to reviewing the elements that inform the price cap. We welcome the commitment of the CAA to exhaustive analysis of the issues and the opportunity to submit our response to the proposals published by them.

1.2 Despite its problems post 11 September, NATS has made a great deal of progress since the PPP in 2001. The system of economic regulation, along with the new framework provided by the Transport Act and the Licence conditions have played a significant role in this along with the new management and control by the Airline Group.

1.3 The table below compares the costs per km with other comparable Eurocontrol States. It shows that NATS has made significant progress in the last few years but that there is still room to move towards the industry average. We understand that a recent draft update of this analysis confirms both the position of NATS and improving trend.

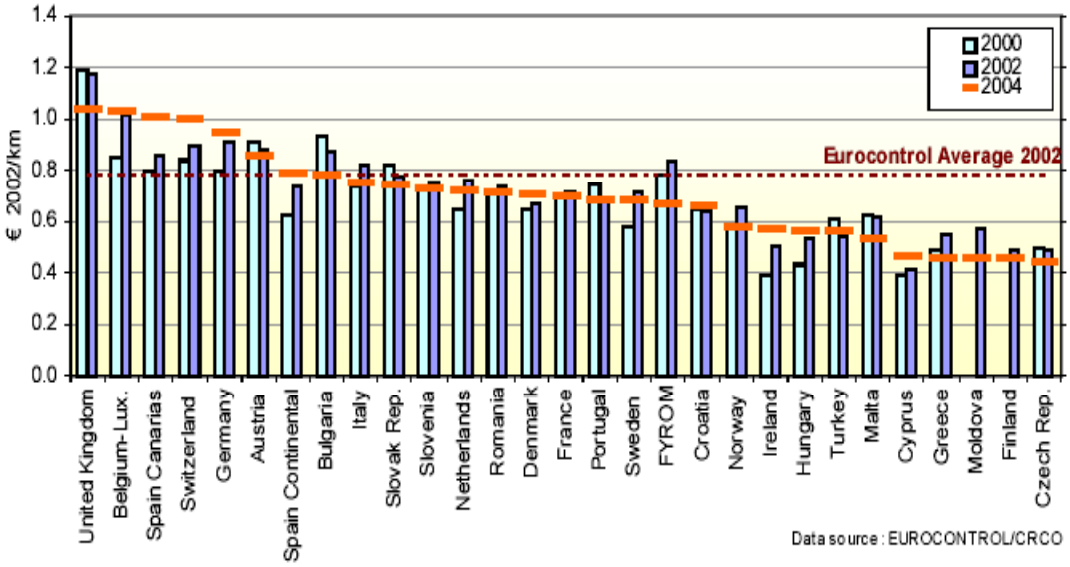

Figure 42: Unit costs per State

1.4 Economic regulation has so far provided important benefits to airlines and we consider the CAA's initial proposals for CP2 as a move in the right direction.

1.5 NATS has a contribution to make to achieve the lower prices and higher productivity anticipated by the PRC. As the national regulatory body the CAA has the opportunity to establish a regulatory settlement that incentivises NATS to deliver this in the overall public interest. This involves striking a reasonable balance between the need to deliver enhanced capacity and improved service standards, while continuing to drive towards a more competitive and efficient cost base.

Timetable and Possible Reference to the Competition Commission

1.6 Given the CAA have extended the response time for this consultation by a month the revised timetable for the review set out by the CAA seems a fair balance of the need to accomplish the same workload in a slightly shorter timescale.

1.7 BA supports the CAA's proposals for implementing the CAA price caps on an interim basis if NATS refers the decision to the Competition Commission and then recovering any differences over the course of the remaining years of the Quinquennium. We consider the details of this arrangement as set out in Appendix 1 of the CAA's proposals to be a workable methodology for doing this.

2.0 Industry/Economic Climate

2.1 In considering the appropriate treatment of the financial risks facing NATS during the CP2 period, it is important to remember that airlines - the principal users of NATS' air traffic services - are themselves exposed to an even greater degree to many of the same risks.

2.2 The sharp fall in air traffic in 2001 and subsequent years – arising from the global economic downturn and events such as the terrorist attacks of September 2001 – gave rise to severe financial difficulties for NATS, and prompted the adoption of the Composite Resolution in 2003. This reduced the degree of NATS' risk exposure, among other ways through the introduction of a risk-sharing arrangement with users in the event of weaker than expected growth in air traffic.

2.3 Airlines already act to mitigate the risks facing NATS through their own commercial actions. Their first response during a period of weaker than expected demand is typically to cut prices. Passengers may also seek to save money by switching to cheaper flights, such as those offered by the no frills carriers. This offsets some of the weakness in the volume of air traffic, and helps to maintain the number of flights – though with weaker airline industry revenues. This serves to insulate infrastructure providers such as NATS, whose revenues are volume-related, from some of the worst effects of a downturn in demand.

2.4 So while NATS saw only a modest reduction of 0.3% in total CSUs between 2000 and 2003, global network airlines experienced a much bigger cut in their revenues and in their profitability. There has been strong recovery in air traffic volumes in 2004, though part of this is due to the rebound from the adverse impact of the Iraq war and SARS on air travel in 2003. Even so, traffic only surpassed 2000 levels during 2004, and current levels fall well short of a full recovery of the traffic *growth* lost during the intervening period. Airline yields – and hence revenues and profits – remain under strong downward pressure as a result of the competitive nature of most air travel markets. BA's own yields have fallen by 10.5% in the last three years – a drop of around 17% in real terms, and we have been forced to cut costs aggressively in response.

2.5 It is therefore important that monopoly suppliers such as NATS should not be allowed to exploit their position of relative strength in the aviation supply chain, at the expense of airlines who face an array of monopoly service providers while themselves struggling in intensely competitive markets. The process of regulation should seek to mitigate – rather than exacerbate – the fundamental competitive imbalances that exist in the supply chain.

2.6 We therefore expect the CP2 price cap to represent a fair balance between risk and reward – allowing scope for necessary investment and service quality improvement while continuing to offer a strong incentive to deliver cost efficiencies. NATS should clearly be rewarded for good performance, but they should not be unreasonably protected from the uncertainty that faces all business, especially if it is at the expense of users who already suffer a significant risk exposure.

3.0 Approach

Statutory Objectives

3.1 BA welcomes the CAA's intention to keep the maintenance of safety a primary consideration and that the CAA has liaised with the Safety Regulation Group to ensure that nothing in the proposals jeopardise, or might be expected to jeopardise, safety. Looking forward, it should be possible to review restrictions if they push NATS' costs significantly above those of other ANSPs, which operate safely. As with all regulatory restrictions, there are often different ways of achieving the same aim and many older safety restrictions were probably developed without the rigour of thorough regulatory impact assessments. Therefore while safety is the primary requirement of users, as well as NATS, we would expect the CAA to take into account the possibility that particular safety restrictions can and should change if more efficient ways of addressing safety needs can be found.

3.2 After considering safety the CAA should establish policies that further the economic interests of users as this is the purpose of economic regulation and the reason why NATS can refer the CAA's decision to the Competition Commission (CC) or can ask for a mid term review but users cannot. We agree that the interests of users can be furthered through promoting the efficiency and economy of NATS. In considering the scope of the restrictions the CAA should not make it an objective to impose the minimum of restrictions but rather aim to implement a regulatory framework which is no more than required but also no less than that which is required to further the interests of users.

Principles

3.3 In our 04 July 2004 submission to the CAA we indicated that subject to the comments below, which we repeat for ease of reference, the principles established by the Better Regulation Task Force establish an appropriate framework for guiding an approach to regulation.

Proportionate

3.4 In general incentive regulation is to be preferred over prescriptive regulation as long as the incentive structure proves to deliver that which is expected and results in efficient costs and high service quality. If it does not, this should be recognised and prescriptive corrective action taken.

Accountable

3.5 We welcome the CAA's recognition of its accountability to all the stakeholders in the process and its intention to expose to public scrutiny both its decisions and the reasons for those decisions. However, accountability to users cannot be achieved merely through transparency (which in any case is one of the other principles). Accountability to NATS is built in, since they can refer the decision to the Competition Commission. However, airlines have been given no remedy against poor regulatory decisions because Parliament's expectation is that the system of economic regulation is there primarily to safeguard their legitimate interests. Accountability therefore requires the CAA to secure positive support from users for its decisions. While it is unrealistic to expect all users to agree to all elements of the decision, the CAA should be able to secure broad support from major users and/or major user

associations given the statutory objectives. If it cannot, this would indicate either that there was something wrong with the decision and/or that the process had failed to engage adequately with users.

Consistent

3.6 Whilst agreeing that the CAA should have an overall objective of consistency, this should not be at the expense of implementing the decisions required to meet the duties of the Transport Act.

Transparent

3.7 The most important aspect of transparency is explanations of the rationale for particular proposals/issues in terms that non-specialist staff can grasp easily. While the content of the work depends on economics, finance and the law, it should not be assumed that specialists in these disciplines are on hand to review the consultation papers. Even in large airlines and industry associations, involving these specialists in the regulatory process increases the costs dramatically.

Targeted

3.8 It is important for the CAA to target the areas where users consider the maximum benefit can be obtained from the application of economic regulation.

3.9 We also indicated that **Effective Regulation** should be added as a principle to the list above. The form of regulation should be effective in delivering results. Such a results-oriented approach should recognise that while individual elements of the package might make sense, what is most important is that the overall package is coherent, addresses the monopoly problem that economic regulation was set up to deal with and meets the CAA's statutory duties.

Context for the Review

Ownership Structure

3.10 Since the members of the Airline Group (AG) are required to act in NATS' interests and cannot run the company for their own benefit their influence is restricted. The existence of the AG cannot compensate for broader financial incentives set by the regulatory framework. Therefore we welcome the conclusion by the CAA that positive effect of the presence of the AG should be buttressed by economic regulation.

3.11 The CAA has commented on the manner in which the presence of the AG has facilitated a more transparent and open approach to the review. This has manifested itself in the sharing of draft terms of reference and cooperative approach to consultants' studies. We believe these terms of reference, particularly on benchmarking, should have been shared with users whose input at the inception stage to these studies would have further improved the credibility of the outputs.

Financial Structure

3.12 BA welcomes the CAA's recognition that the regulatory settlement should balance NATS' reward with the risk it faces and that the regulated company should not have

the option of influencing the level of incentive risk placed on it choosing to finance itself through debt rather than equity.

3.13 The CAA rightly expects NATS to reduce its gearing over the course of CP2 but this should not be through allowing them a higher cost of capital – in part to enable a reduction in gearing. NATS is already a very low external risk business with a near 100% monopoly of UK airspace with good certainty of long term demand growth and low risk of defaulting payers.

Main Issues

3.14 We welcome the proposals by the CAA to retain both the RPI-X form of price control and the 5-year regulatory period. It also makes sense to continue to set the price control by reference to NERL's RAB. However, the asset base should be based on consistent historic values with the amount and basis of depreciation in a regulatory period agreed as part of the regulatory settlement. The asset base should not be manipulated to influence levels of returns. One consideration that requires more thought is how to treat software, since the value and depreciation of this asset may be different from traditional regulatory assets. In addition to the points above originally outlined by the CAA in March 2004 we welcome the fact that the initial proposals address our concerns on the level of consultation from NATS.

4.0 Scope of the Control

Terminal Approach Services

4.1 BA welcomes the proposal by the CAA to extend the scope of regulation to include the Terminal Approach Service. This is a "Core Service" under the Licence that is currently not open to competition but is not price regulated. As a monopoly that is in principle no different from the components of NATS that are already regulated it is appropriate for the Terminal Approach Services to be brought within the scope of price cap regulation.

4.2 The CAA is correct in noting that any increase in the Terminal Approach charges to bring them into line with costs would need to be off-set by an equivalent reduction in En-Route charges. Since there are contractual arrangements in place at the moment for Terminal Approach services it will be important for the CAA to set out a transparent process for the rebalancing of these charges.

4.3 Also if the regulation is extended to include this service it will be important for the delay figure on this service to be consistent with the Service Quality regime without resulting in a slackening of the overall framework.

Single Till versus Cost-Based Approach

4.4 In our 04 June 2004 submission we indicated we saw a logic in applying a cost based approach to setting the regulated charges which did not subsidise the unregulated aspects of NERL's activities. But it would be difficult to come to a definitive view without more information on the feasibility and robustness of allocating costs accurately.

4.5 We welcome the comprehensive study conducted by KPMG into NATS' cost allocation procedures. This study has indicated that NATS processes lacked adequate transparency and that KPMG had reservations around NATS' model structure and lack of meaningful output for the CAA. The concerns of KPMG led them to indicate that further work would be required to test the accuracy of the current methods. Quite apart from the single till/cost based question it is a serious issue to us that a third party expert should have concerns about NATS cost allocation methodology. This issue should be addressed for itself to ensure that the correct costs are borne by the right users without services being allocated twice. We look to the CAA to ensure that the overall regulatory settlement for CP2 is based on a robust cost allocation process so that users can be assured that prices are not artificially inflated to make up for inefficient cost allocations.

4.6 The terms of NATS' contract with the MOD should reflect the true costs of NATS providing the services and the infrastructure (e.g. primary RADAR) to support these in a way which provides a return equivalent to the return expected from commercial users. This would hold true in both a single till and cost based environment.

4.7 The CAA indicates that the final decision will be taken after NATS have finalised the next contract with MOD and after further analysis by KPMG. The difficulty around deferring this decision, in the absence of clear guidelines, is that NATS may be tempted to price the MOD contract below actual cost in order to retain this business, leaving regulated users to pick up the difference. If once the actual costs are known it transpires that this is the case contractually NATS will not be able amend their

pricing with the MOD. There should be some safeguard for regulated users to ensure we are not unfairly exposed to this risk should it materialise.

5.0 Structure of the Control

5.1 We welcome the intention of CAA to adopt a system in which the drivers of revenue reflect, as far as possible, NATS underlying cost structure. It is in the best interest of efficient use of the scarce resource of available airspace if the charges paid by users are as closely related as possible to the cost they are designed to cover. This gives users the best incentive to use the airspace efficiently, and helps to give NATS some assurance that incremental costs incurred in expanding output are likely to be matched by additional revenues.

5.2 BA agrees that NATS is as well placed as users to mitigate volume risk. This is because ATC charges are a significant cost that airlines bear when making route and frequency decisions and NATS has the ability to mitigate this risk by incentivising greater volume through adjustment to unit charges. Airlines may choose to fly more if the costs of flying are relatively less and so can make their own routes profitable as a result. NOTA is a good example of this as a relatively cheaper portion of airspace that has attracted volume. The 50% fixed and 50% volume-based revenue approach has the effect of insulating NATS from a degree of risk and this should be reflected in a price cap that recognises the reduced risk borne by NATS.

5.3 The CAA is correct in stating that weight has no correlation with the amount of cost NERL must incur to service flights and because it would have the effect of reducing NERL's revenue risk allow more risk to be placed on the service quality elements of the regulatory settlement. We urge the CAA to apply this logical insight to the decisions reached for CP2 and lobby the UK Government, EC, and Eurocontrol to adopt a charging mechanism that is based on distance flown rather than a composite of this and aircraft weight.

5.4 We do not consider that a charges smoothing mechanism, which allows under/over recoveries to be adjusted over several years, would be beneficial to users. The CAA is correct is noting that with adjustments over long periods there is a danger that costs and revenues would be out of line in any particular year. This is a situation that should, as far as possible, be avoided due to the complexity it could bring to annual charges consultations and the unanticipated consequences to users of not being able to budget for the latter years of CP2 as accurately as possible. In the extreme a long smoothing period could add unnecessary complexity to calculations at the end of CP2 and the forecast for CP3. This would not be in users best interests. Nor would it be in keeping with user's preference to pay for services as close as possible to the time of consumption.

5.5 The CAA rightly notes any risk that NERL bear on the CAA/DfT element of the charge is passed on to users. Therefore, NATS is not incentivised to challenge any increases proposed by the CAA/DfT. This is evidenced by the prospect of a 12.2% increase in the DfT component of the charge in 2005. We believe it would be in the public interest for NATS to be empowered to resist cost increases in its supply chain in the same manner as all companies operating in a competitive environment. We do not consider that it would be onerous for a mechanism that provides such incentives to be established for NATS. One approach could be for NATS to share with users any rises/reductions that are higher/lower each year than the CP2 price cap.

5.6 BA does not consider that any under/over recoveries at the end of CP1 should be accounted for by adjustments to the RAB. We believe these should be transparently reflected in charges in the first year only of CP2.

6.0 Traffic Volumes

6.1 We are in broad agreement with the CAA's proposed assumptions for growth in traffic volumes during the CP2 period, and support most of the proposed adjustments to NATS' own projections.

6.2 However we acknowledge the considerable uncertainty involved in all projections of air traffic growth and in the number of flights. As well as the influence of the economic cycle, air travel will be affected by trends in a wide range of variables, such as air fares, exchange rates, aircraft size, market maturity, and airport and airspace capacity constraints, as well as by the strategies pursued by individual airlines and airport operators, which will for example influence the number of transfer passengers using UK airports. The current outlook is especially difficult to predict with any confidence because of the number of special factors and once-in-a-cycle events that have recently affected air travel growth.

6.3 In general, we believe that long-term trends in growth rates provide a better guide to future patterns of air travel than extrapolating the pattern of behaviour over a shorter time period, such as the past year or two. Over an economic cycle, periods of stronger growth are typically followed by spells of slower growth – or, as in the case of 2000-2003, actual contraction. As long as the relevant period includes both upswing and downswing phases of the cycle, the average growth over such a period should provide a reasonable representation of underlying growth rates.

6.4 The period 1992 to 2003 may form such a period. It begins just after the trough of the early 1990s downturn in global air travel, and ends in the weakest year of the latest downswing – ie before the strong rebound in air traffic seen in 2004. The average annual growth in CSUs of 4.5% over this period is therefore a reasonable basis on which to build any judgment about future growth rates. Even allowing for greater market maturity in the CP2 period, NATS' projected growth in CSUs of an annual average 3.1% accordingly looks low.

6.5 We are therefore inclined to support the CAA in their view that NATS have been unduly influenced by the weak growth trends in the last few years, and have not taken sufficient account of longer-term trends. Nevertheless we acknowledge that there are many additional factors which should be taken into account in assessing future rates of expansion of air travel. Some of these are raised by the CAA, and we discuss them in turn below.

International-to-International Connecting Passengers

6.6 We agree with the CAA that NATS are significantly under-estimating the potential growth in the number of passengers connecting between international flights at UK airports, especially at Heathrow airport.

6.7 At a severely capacity-constrained hub such as Heathrow, growth in the underlying market for point-to-point travel might be expected to squeeze out less profitable connecting traffic if capacity growth cannot keep pace with demand. This factor was especially relevant in the late 1990s, when BA was providing too much capacity for the underlying size of the market. Some of this capacity was therefore dedicated to carrying unprofitable transfer passengers, who paid low fares while the transfer process itself incurred additional costs.

6.8 Following BA's capacity downsizing (now complete) of the last few years, there are now fewer empty seats to be filled. Most of the passengers that currently connect between international flights at Heathrow do so at commercially acceptable fares, and are naturally generated by a major hub airport that serves a large number of destinations. The number of international interliners at Heathrow is now driven principally by the faster growth of longhaul than shorthaul services – a trend that is expected to persist while the airport's capacity remains constrained.

6.9 Many shorthaul services can be provided effectively at other London airports. But longhaul services cannot readily be switched away from a large international hub such as Heathrow, because they rely to a greater extent than shorthaul on connecting passengers. Airlines seek to ensure that connecting (mainly shorthaul) flights can provide sufficient transfer passengers to sustain a commercially acceptable load on longhaul flights.

6.10 As the CAA says, the slow growth in the number of interlining passengers in recent years is a reflection of the downturn in the longhaul travel market, especially across the North Atlantic, and consequent reductions in the number of flights. We are therefore content with the CAA's proposed assumption that the unconstrained level of demand for connections will grow at levels "close to the underlying unconstrained growth in local markets".

6.11 However we note that the entry into service of larger aircraft such as the A380, and the opening of T5 at Heathrow in 2008 - which will accommodate additional passengers - may allow more rapid expansion in the number of interlining passengers. T5 for instance should improve the attractiveness of flight connections by reducing the need to switch between terminals.

Regional Share of Transatlantic Arrival/Departure Traffic

6.12 Longhaul services need a strong local demand, as well as a supply of passengers interlining on connecting services, in order to achieve a sustainable level of demand. This has served to limit the number of longhaul services that have been successfully established from other UK airports apart from Heathrow, including regional airports. We therefore agree with the CAA that NATS' traffic projections may be over-stating the likely gain in regional airports' share of these services during the CP2 period, and we support the CAA's proposed revisions.

Regional Share of Western Europe and other Traffic

6.13 Conversely, we believe that there is greater scope for expansion of shorthaul services at regional airports, especially as Luton and Stansted airports – the location for much of the expansion of services by the no frills carriers in recent years – become progressively busier, and hence unable to offer the same attractive opportunities for similar growth in future. Again therefore, we are inclined to support the CAA's proposed assumption.

Other Assumptions

6.14 We are content with the CAA's assumptions on average distance of overflights, domestic seat factors and domestic aircraft size. We also agree that the impact of airline bankruptcies, or other forms of airline consolidation, should not be identified

separately as a specific factor influencing traffic volume growth, as it is just one of many possible structural changes within the airline industry. It is also difficult to specify a single year – in this case 2005 – for such changes. In practice, airline consolidation is likely to be a protracted and gradual affair, spread over several years.

7.0 Service Quality

General Comments on the Delay Term

7.1 BA welcomes the CAA's proposals to strengthen the delay term as a means of increasing the emphasis on service quality in the economic regulation framework. If calibrated well, a stronger delay term would improve the alignment of NATS's interests with those of their airline customers – and with those of airline passengers.

7.2 In our view, the inclusion of a modest delay term in CP1 – and the retention of this in the composite solution – has had a powerful effect on service performance. It may not be possible to prove this by examining the results so far and in any case the term was set at a very weak level. However, it has been influential for two main reasons:

- it reinforced an internationally established measure, for which an annual league table is published;
- it was made clear that NATS' future performance would be judged on this basis, that there would be close monitoring and that the term was likely to be strengthened in the next control period.

7.3 Thus the financial effects of the term in the current control period have not been significant, but the regulatory signals have helped to change NATS' attitude and approach to delay and this has been helpful given the fact that change takes time to achieve.

7.4 We agree that it is difficult to relate average delay to the impact on individual flights and that the real value of the measure is because it works as proxy for the overall shortfall of capacity against demand. Therefore, it does create an incentive on NATS to address delay problems. Its weakness is that NATS may simply try to go for easy wins rather than focus on the issues of greatest importance to airlines – and the priorities might therefore be different. Also, it does almost nothing to compensate airlines for the costs of delays generated by NATS. Its only real value, therefore, is to better align the interests of NATS with those of their airlines customers.

7.5 To NATS' great credit, once Swanwick was implemented and their financial crisis was resolved, delays were quickly brought under control and their system of monthly reporting has been very clear and open. They have also set up the OPA to try and improve their estimation of future demand. We believe that NATS now treats delay as a key performance indicator and as a corporate priority and this is due largely to the innovative approach taken by the CAA in CP1. Before the ppp, NATS would defend delay as a necessary measure to enable them to balance supply and demand.

Capacity vs Delay Measure

7.6 Since NATS finds it difficult to respond at short notice to dynamic changes in the air transport market, it is understandable that they would like to create more certainty about future demand as far ahead as possible. We support the OPA as a means by which airlines and NATS can review future capacity needs and BA is committed to this process.

7.7 However, NATS cannot expect to gain long term *certainty* about future demand, nor can they expect users to come to a coordinated view especially at a detailed level. Air

transport markets are becoming increasingly liberalised and ever more responsive to passenger needs and to external economic pressures. This means that NATS, as well as airlines, must find new ways to live with market uncertainty while also increasing their ability to plan ahead. The regulatory system should not shield NATS from market risk, at the expense of NATS' customers, but should provide incentives for NATS to manage risk well. Therefore a capacity term would be inappropriate in principle given that NATS has a statutory monopoly and is obliged to cater for future demand under the Transport Act.

7.8 For these reasons, and also for the reasons the CAA gives in its paper, which we endorse, we agree that the regulatory incentives should continue to be based on delay and not be changed to capacity.

The Importance of Clear and Consistent Regulatory Signals

7.9 Clearly, when NATS was a public sector monopoly with guaranteed income and no penalties for poor performance, their business did not need to operate very flexibly. Now that NATS is operating as a commercial business, they have started to reorganise internal processes. The CAA has noted some obvious examples of this (rostering changes and voluntary overtime). Given time, we believe that more fundamental adjustments are possible. Therefore it is essential that a consistent long term approach is taken by the regulator.

7.10 However, given the primacy of safety, we don't advocate setting aspirational targets based on optimal performance. Economic regulation can help by placing similar pressures on the organisation as they would face in a competitive market. The regulator is therefore entitled to expect NATS to change its business approach over time, with the involvement of their key stakeholders. We therefore believe that NATS is more likely to try to respond positively to consistent long term regulatory pressures which build on previous decisions.

CP2 Considerations

7.11 In CP2 the challenge is not just to incentivise NATS to deliver service quality, but also to incentivise long term investment decisions. Since the standard RPI-X approach to regulation provides weak incentives to target investment into service quality improvements, a meaningful delay term can play a key role. We were surprised not to see more emphasis on this in the CAA paper. A strong delay term would make it more likely that NATS would deliver the funded investment programme and would not thrift those aspects that are more directed towards quality improvement than towards capacity expansion.

7.12 In practical terms, the fact that more of NATS' revenue will depend on their own performance should create financial incentives to:

1. anticipate congestion and plan ahead realistically, putting contingency arrangements in place to address inevitable market uncertainties;

2. strengthen business continuity arrangements to manage business risks associated with increasing dependence on IT systems and automation;

3. build more flexibility into processes for matching capacity to demand, by shortening lead times, reducing resource allocation constraints etc;

4. develop targeted, non-discriminatory financial incentives to encourage users to contribute to capacity building or delay reducing measures, as permitted under the new Single European Sky regulations;

5. manage projects well to ensure planned improvements are delivered.

Form of the Term: Weighting

7.13 Of the two options proposed, we support Option B. We agree that early morning delays and long delays cause knock on consequences and that this change to the form of the control would help to create the best incentives.

7.14 The University of Westminster Report found that long delays were much more costly than short delays because they could not be planned for and absorbed. The consequences of long delays include, for example:

- The risk that air crew will go "out of hours" and have to be replaced;

- The risk that when the flight finally arrives at its destination, there is insufficient time to turn around and get the departure away on time, causing a "reactionary" delay;

- The risk that critical parts of the airfield become congested (especially the stands), so that arriving flights can be affected by delayed departures;

- The risk that flights have to take off after the start of the night restrictions period, requiring other flights to be delayed or cancelled to ensure the airport remains within the Government's limits.

7.15 If any of the above risks materialise, there is likely to be a snowball effect. None of the above risks are likely with a short delay and the longer the delay, the greater the risk of costly consequences.

7.16 Option A ignores the fact that long delays later in the day can also cause severe knock on problems, especially if this continues beyond the start of the night restrictions regime. If so, cancellations and night stops become inevitable and there would be large costs and knock on effects into the next day. These problems would not be captured under Option A.

7.17 We therefore welcome the CAA's proposed change to the structure of the delay term and recommend option B.

Cost of Delay and Symmetry Issues

7.18 We cannot comment on whether or not £6 per minute of delay represents NATS' marginal cost of adding new capacity. However, this is clearly dramatically less than the cost of delay to users (as noted, the estimated cost is £48/minute for delays above 15 minutes).

7.19 In setting the rate, the CAA needs to take into account the fact that airlines need to plan their schedules on the basis of expected delay. While better than expected performance by NATS is clearly of benefit, much of the delay cost would remain locked into schedule timings and crew rosters which can be changed only on the basis of sustained long term improvements. Therefore there is a large asymmetry in delay costs: worse performance than expected will create much larger costs than the equivalent saving created by better than expected performance. In the case of airports, where the symmetry question was considered in detail at the last review, it was decided that BAA would not receive any benefits for outperforming service standards.

7.20 Despite this, there may still be a case to incentivise NATS to improve performance beyond the par value. However, we do not support a single rate of £6/minute for both bonus and penalty. The current term is asymmetric and this asymmetry should be retained even if the CAA rejects a penalty only regime for CP2.

The Par Value

7.21 Under the CAA's proposals, NATS is expected to receive large payments from airlines, even if delays double from current levels. It seems bizarre to reward NATS for deteriorating performance. Under the CAA's proposal, NATS would compensate airlines only if traffic was higher than the high case and NATS did nothing extra to improve performance.

7.22 We do not accept the basis for setting the par value at 1 minute, corresponding to NATS' estimate of the high growth case. In the SIP discussions, airlines have consistently told NATS that 1 minute delay is too high and is well above the Eurocontrol target – as noted by the CAA in its supporting paper on service quality (6.19). Therefore this is not an acceptable par value, especially given that the term involves bonus payments.

7.23 We recommend that the par value is set at 0.5 minutes corresponding to the base case assessment and current performance. While 0.5 minutes is still above the optimal level (as assessed by Eurocontrol), it would be a fair compromise and would be fair to NATS because it represents current performance. Since revenues will be allowed to NATS on the basis of the base case, NATS would have substantial additional revenues if high growth materialised either to manage delays (ideally) or to compensate airlines if additional measures were not possible. Under the CAA proposal, all the benefits of higher than expected growth go to NATS and none of the delay costs (unless growth is above the high case).

7.24 We accepted the case made by the CAA in CP1 that the par value should be set on the basis of achieveable performance. A figure of 0.5 minutes is clearly achieveable. Even if the CAA believes it would be too large a step to go straight to 0.5 minutes, the par value should as a minimum reduce in steps to 0.5 minutes well before the end of the control period. This would provide a clear regulatory signal that long term efforts to manage delay are needed while rewarding NATS for gains early in the period. It would also ensure that any bonuses paid to NATS in the early years were matched by a commitment to long term improvement. The current proposal gives the unhelpful impression that 1 minute average is acceptable and anything better than that is a bonus (see 7.9 of the SQ supporting paper). 1 minute is not a standard that airlines recognise and is not acceptable as the basis for a long term par value.

The Ceiling

7.25 It is hard to follow the logic of placing a £20m ceiling on the term. Provided that NATS manages its business in accordance with its own plans, the only circumstance in which they would have to make payments is when there is high traffic growth. Since the additional revenues from such growth would far outweigh the penalty costs, even given the weightings and the additional costs incurred by NATS, in practice there is no net revenue risk. There are risks only if delays rose but traffic remained at or below the base case assumptions. This would result from poor management. In this circumstance it is only fair that NATS would not to be able to make its expected profit. No business can expect to receive guaranteed profits however well they perform. The CAA does not seem to have taken this into account in its discussion on the ceiling and its evaluation of the risks that NATS could bear (7.17-7.22 in the SQ supporting paper).

7.26 The ceiling also raises problems of incentives if performance deteriorated, beyond 2.3 minutes. In such a circumstance, there would be no financial incentive to minimise delay beyond that point. Although this is a very high figure, delays in 2002 averaged 2.6 minutes, significantly above the proposed ceiling. The term is supposed to reflect a realistic range of actual performance outcomes.

7.27 Therefore the £20m ceiling on the penalty is too low because it does not take into account the actual risks or fairness and fails to work as an incentive to avoid very long delays.

7.28 In addition, the CAA does not seem to have taken into account the fact that if more potential revenue was at risk, NATS would have even stronger incentives to put in place a wider range of delay management measures, such as incentivised agreements with airlines and/or with neighbouring ANSPs. If the term is capped at £20m, more ambitious measures may seem to be hardly worth the effort.

7.29 We believe that the CAA should also take into account the fact that in an extreme case, the price cap can be reviewed by NATS but not by airlines. Clearly because of the AG ownership of NATS, airlines would support any such review if NATS were placed in serious difficulties because of an extreme external event - as we did in 2002. The fact that airlines would not allow NATS to fail should be taken into account in any assessment of risk.

Other Dimensions of Service Quality: MDIs, Cancellations, Re-routes, Level capping

7.30 While ATFM delay is the most important measure of service quality besides safety (which we agree should be subject to absolute controls and not to financial incentives), there are other important dimensions, which should not be ignored. In particular:

- MDIs (minimum departure intervals) are imposed by NATS on an airfield to limit departure flows if there are airspace capacity constraints;

- When there are severe delays, many airlines will cancel flights, sometimes pre-emptively, so as to manage the problems. Under the current approach, very costly actions by airlines serve to reduce the true scale of delay problems;

- Similarly, re-routes and level capping are measures that airlines accept frequently as practical ways to reduce delay – the costs of these actions are borne by airlines (especially if longer routeings are flown) and serve to reduce the apparent scale of delay problems.

7.31 There are no measurement systems to capture these costs or the scale of activity. Clearly, without measurement and reporting, it is difficult to appreciate the extent of the problem or the need to deal with this through the regulatory regime. If there is no action, NATS could have perverse incentives to mange/reduce delay by shifting the burden more onto users by increased use of these measures. This would create the appearance of improvement.

7.32 We therefore recommend that NATS develops appropriate measures in these areas and reports performance monthly. The CAA would need to commit to monitoring performance and, on the basis of the data, to decide later whether to introduce new measures. However, we would hope and expect that greater visibility and monitoring would in itself be of benefit since it would signal the importance of managing these dimensions of performance and would provide the data to allow for direct discussions between NATS and the airlines about appropriate use.

8.0 Operating Expenditure

8.1 Since operating expenditure accounts for approximately 70% of NERL's revenue requirements it is essential that the regulatory settlement contains policies and incentive properties that are appropriate for NATS, given its history and position in the market..

8.2 In 02/03 and 03/04 NERL demonstrated its capability to out perform efficiency forecasts when required. Therefore it would be in the public interest for the CAA to put in place a level of incentive that requires NATS to expend management effort to achieve continuing cost efficiencies.

8.3 The CAA's proposals indicate non ATCO head count is forecast to reduce by about 15% but that this saving will be lost through increased salaries for the remaining staff. The CAA should ensure that NATS passes through some of this saving to users rather than use it up in salary increases.

8.4 It is anomalous that users should be expected to pay for a NATS £25m contingency fund for extra manpower costs in case frontline systems are delayed. This would mean that users would be doubly jeopardised if such systems do not come online because users will be paying for the capex cost of these undelivered systems and also not yet experiencing the benefits expected. It is therefore unfair to expect users to pay for the opex contingency required by NATS to compensate for not delivering the investment. This is a good example where the correct incentives of NATS not being able to pass on the costs of under delivery could focus management on delivering as planned.

8.5 Given NATS' capacity to find savings in CP2, the added incentive of the rollover mechanism and the potential for efficiency improvements described by the consultants retained by the CAA to review NATS opex it is reasonable to expect NATS to achieve significant opex savings in CP2. In our view, the CAA is targeting the lower end of potential savings, and there should not be serious operational or service quality risks from the efficiency gains they have assumed. As a world class ANS provider NATS should be expected to keep up with industry best practice

8.6 It is stated in the main CAA CP2 paper that staffing levels in NERL corporate functions compare favourably generally in relation to other firms. It is noted from the KPMG paper that this is the case for Finance, and IT, but is inconclusive for facilities management, where further benchmarking is required. Furthermore the KPMG paper states that there is more outsourcing in IT than the norm, therefore a reduced functional headcount would be expected from such a policy.

8.7 The main CAA paper recognises that salary levels for central corporate functions tend to be higher than the median and states that this should unwind during CP2. For Finance, IT and facilities, the KPMG paper clearly substantiates the fact that salaries are higher than average and clarifies that Swanwick relocation is a major factor in this situation arising. We are concerned that this situation may not unwind in CP2 due to a couple of factors highlighted in the KPMG report. These are planned above inflation wage rises on existing salary levels and no firm plans by NATS as to how to tackle higher than average salary levels over the control period.

8.8 The Performance Review Commission has indicated that it expects unit costs across Europe to fall by 3% per annum over the next 5 years. It would be reasonable to expect NATS to outperform this given they are already in the private sector and

posses more incentives/capability to find efficiencies. This further strengthens the case for a challenging target for NATS.

8.9 In addition the CAA appears to have allowed extra opex based on NATS planned expansion in capacity that is higher than forecast traffic levels. This is designed to allow NATS to accommodate higher than expected levels of traffic. The CAA should only allow opex costs for growth that is in line with agreed traffic forecasts. To allow more would result in a cost base that users are remunerating which is higher than necessary.

8.10 It should be noted there is not a 1:1 relationship between traffic growth and ATCO numbers. That is to say, given the current and planned sectorisation of the UK there is a finite number of ATCOs that can be operational at any one time. It is important to note the equivalent number of ATCOs this growth equates to in order to make the link to the operational sectors. In addition the iFACTS and EFPS projects are designed to reduce the number of ATCO assistants.

8.11 The CAA identifies the transport and communication sector benchmarks giving a annual real cost reduction target of 3-4 %. Therefore, since opex makes up 70% of NATS costs and the KPMG figures show a minimum improvement capability of 17% over CP2, the CAA target for NATS to deliver 2 % for two years followed by 3 % for the remainder of the control period should be achievable. Sufficient scope exists for more efficient procurement, productivity improvement and support staff savings to ensure they can be delivered without compromising operational effectiveness. (See Appendices 1-3 for detailed comments on the efficiency studies conducted by consultants for CAA.)

Efficiency Rollover Mechanism

8.12 We agree with the CAA that the incentives to make efficiency savings on operating expenditure are greater if a regulated firm is able to retain the benefits for a full five years, regardless of the point during the price control regime at which the savings are made. In principle, we are therefore content to endorse the CAA's proposal to retain the efficiency rollover mechanism during the CP2 period. However we would stress the importance of ensuring that the adjustments to the RAB in subsequent price control periods are fully transparent and that the incentives on NATS to make operating efficiency gains are not watered down under the rollover mechanism. We therefore agree with the CAA's intention to incorporate any adjustments – such as the proposed Year 2 component– necessary to minimise perverse incentives that might encourage NATS to behave in an inefficient manner.

Pensions and Radio Spectrum Costs

8.13 The CAA is proposing that NATS should be able to pass through in full any additional costs of these items, recognising that they lie largely outside NATS' control. The logic of this is that since NATS have little influence over these costs, which are determined exogenously – for instance by the impact of financial market behaviour on NATS' pension fund, or by decisions by Ofcom on the pricing of radio spectrum allocations.

8.14 However we have two areas of reservation about this approach. Firstly, we are concerned that such an approach could weaken the incentives on NATS to make

efficiency gains in those areas where it does have some element of control. For instance, it would be unacceptable if NATS were able to benefit from savings in operating expenditure such as those that could be made by cutting back on pension contributions, at the expense of higher costs in future. We therefore urge the CAA to take this incentive effect into account when setting the proportion of total pension costs that is to be passed through to users, and we await a clear demonstration of the basis on which the CAA estimates this proportion.

8.15 Similarly, airlines would be denied the ability to influence decisions on spectrum management by the automatic pass-through. Charges are intended to ensure that spectrum is used efficiently, but NATS would not have any such incentive if costs are simply passed through. For example, NATS may be able to mitigate radio spectrum costs in some cases by installation of new radars.

8.16 Our second reservation is that by allowing the full (or partial) pass-through of certain uncontrollable costs, the CAA is providing NATS with a luxury that firms operating in competitive markets do not enjoy. Airlines for instance have to face many substantial uncontrollable costs, for instance the cost of fuel, and airport and ATC charges, as well as the cost of funding pension payments. If the purpose of price cap regulation is to replicate as closely as possible the conditions of competitive markets, then this proposal is inappropriate. It is another means by which the CAA is protecting NATS from risk. If in no other way, this should be offset by a reduction in the cost of capital.

9.0 Capital Expenditure

9.1 Given the under investment in CP1 we welcome the overall intention of the CAA to consider practical ways to incentivise capex delivery at an efficient cost. We also agree that consultation should be improved. However, this should not just be at the business planning phase but also throughout the delivery of the investment with accountability to users and the regulator for the delivery of the capex plan as agreed. The CAA considers the presence of the AG as factor that will promote investment to the degree that light handed regulation might be appropriate. We do not think this is so. NATS has consistently under invested against the plan in CP1 not withstanding the presence of the AG. Therefore, the CAA should establish a robust output based incentive structure relying on the presence of the AG as a "belt and braces" approach to ensuring delivery.

Output Users Value

9.2 Whilst delay is an important indicator on the effectiveness of investment other factors can affect delay that are not related to capex performance. Therefore, we do not consider that the level of delay can be a proxy for determining investment delivery. Instead we outline a framework below for incentivising investment delivery.

Under Investment in CP1

9.3 Our information from Business Plan updates and SIP consultations indicate that so far NATS has under invested against the plan in each year of CP1. However, we are still paying the charges designed to remunerate this investment. We need to transparently see how users are going to be compensated for this underinvestment. The CAA indicates in paragraph 8.28 that if, in CP2, NATS spends less than the amount allowed for in CP2 prices, there will be a refund of the difference deducted from user charges from the start of CP3. We believe this represents a fair way of compensating users for the charges paid but for which no benefit has been received. This approach should also apply to the treatment of unspent capex in CP1 and funds equivalent to the level of unspent charges should be deducted from the charges settlement for CP2.

Determination of Capital Expenditure for CP2

9.4 NATS themselves accept that their capex plan for CP2 is ambitious and LogicaCMG, having reviewed the plan, raise a number of concerns around its achievability. Specifically they indicate that projects of the nature planned by NATS typically over run by a factor of 1.7 on timing and 1.3 – 1.8 on cost. LogicaCMG further indicate that for NATS to deliver their proposed plan would mean beating the benchmark data and that the probability of a significant overrun of the programme in time and budget is very high.[1] From a users perspective we recognize that the projects are necessary to deliver capacity and other benefits to us and would these being delivered completely. However, we would want to avoid a situation where at the end of CP2 projects are incomplete and thus not delivering the benefits forecast without any dynamic reductions in charges . NATS past performance in investment delivery gives us little comfort of their ability to actually deliver such an ambitious plan.

[1] Supporting Paper 10 to CAA Initial Proposals - Capex Review LogicaCMG

9.5 We believe the level of regulatory oversight should be in proportion to that required. If NATS had proven their ability to deliver investment a light handed approach to incentivisation could be adopted. However, this has not been the case so more proactive measures are required. The CAA has suggested reducing the level of capex allowance by 80% as being the amount NATS is likely to be able to invest. This is one method of ensuring users do not pay for what is not delivered and we welcome the CAA's initiative in this area. Another option would be for the CAA to allow the full capex plan with a number of robust linkages to the movement of charges if outturn investments are less than agreed in terms of both scope and timing. Our suggestions in this area are discussed below after considering the proposals from NATS for delivering the capex plan.

Incentivising Delivery (improving systems, processes and accountability)

9.6 The CAA has outlined 3 measures put forward by NATS that they believe will improve the delivery of capex outputs. Whilst we welcome the intention of the CAA to focus on delivery we are not convinced the proposals suggested by NATS provide enough incentives or safeguards to users.

Procurement Process Review

9.7 In principle having a plan to improve procurement effectiveness is a welcome move. The NATS paper sets a good high level direction for them to follow. There are a series of visions and objectives to be achieved by July 2006 in order to focus activity. However the measurement and indicators of success are not developed sufficiently and nor do they yet link back to the objectives set out in the paper. Furthermore the cost savings targets seem low relative to total expenditure. It is critical that the CAA prior to publishing its final proposals in May 2005 agrees reasonable measures of success. A fuller discussion of our comments on the PwC Paper on NATS' Procurement Effectiveness is contained in Appendix 1.

Project Management

9.8 We welcome the acknowledgement by NATS that there has been problems in this area in the past and a desire to take steps to improve project delivery. However, whilst the suggested post implementation project reviews have some benefit for garnering learning they will do nothing to dynamically manage delayed projects back on track. In the years before and post privatisation NATS should have been able to develop the skills required the deliver substantial projects. Therefore, a more proactive approach is required to ensuring delivery to scope and schedule than reviewing past performance again. We outline our suggestions in this area below under Capex Milestones.

Transparency of Past Performance / Future Plans

9.9 The consistent and regularly updated presentation of information on past performance and future plans will be useful in enabling users to better track the implementations of the SIP. It should be standard practice for this to occur and we welcome the CAA's indication to NATS that it should modify its SIP to improve reporting in this way. However, improved reporting does not, in our view, provide sufficient assurance that the investment will be delivered as agreed.

Capex Milestones

9.10 It is critical that NATS be properly incentivised and held accountable for the delivery of the invest required to deliver efficient ATC services in the UK. Since the disciplines/incentives that would exist in a competitive market are absent other approaches to ensuring delivery must be found. If investment is not delivered by the monopoly the users, who pay the charges, are disadvantaged in 2 ways; firstly charges are being paid for investment which is not delivered, secondly the expected benefits from the investment are delayed – with operational consequences and increased costs to users.

9.11 The CAA has an opportunity in CP2 to implement a framework which will incentivise NATS to live up to their promises of performance improvement whilst protecting users from some of the consequences if NATS is not able to deliver as expected. We believe this opportunity should not be missed.

9.12 Since charges are levied to fund the capex plan, the key to an effective incentive structure would be the establishment of an objective link between capex delivery and charges. Such a framework is the type of macro solution that would ensure that NATS puts into place effectively all their proposals around improved procurement effectiveness, project management and transparency. NATS' proposals in these areas would all have to be working as planned to deliver their ambitious plans with the true test of their success being delivery of the infrastructure rather than post implementation reviews of the minutiae of NATS' processes. Once such a framework was established it would require less regulatory engagement than the current CAA proposals of ongoing post implementation reviews and the question of how to address poor mid-term performance.

9.13 We believe a mechanism that reflects the model used for procuring software in a competitive environment could form the basis for developing a framework for incentivising NATS to deliver the agreed capex plan whilst protecting users from paying charges without experiencing the benefits expected. At the beginning of the regulatory period the regulator could agree a set of milestones for elements of all the key capex projects that are to be achieved during the first year. At the commencement of the first year the capex allowance for that year could be awarded. At the end of the first year the performance against the agreed milestones could be reviewed. If NATS has delivered to schedule they could then be awarded the capex allowance for year 2 at the beginning of that year. However, if at the end of year 1 they failed to deliver on time or to specification then a proportion of the year 2 capex could be retained against some pre-set limits until NATS reached the milestones agreed for year 1. If NATS exceeded targets by delivering ahead of schedule then they could potentially be rewarded by allowing a higher percentage than the expected amount for year two in order to keep ahead of schedule – a benefit to all stakeholders.

9.14 The types of projects which should have milestones attached to them are:

1. iFACTS, including EPS (Elimination of Paper Strips) which should provide substantial opex savings as it will reduce the requirement for ATSAs in Swanick. In addition iFACTS is expected to deliver substantial capacity gains. Therefore, late or under specification delivery has the potential to directly affect operational costs and performance;

2. TC/LMARS move to Swanick enable NATS to give up the West Drayton site hence providing cost savings on the property lease;

3. CASPIAN is the largest single contributor to capex so should have a set of key deliverables and milestones defined over the course of its delivery schedule. Given the size of this project, it would make sense to break down the capex milestones to include the key Scottish, Swanwick and final TC components - New Prestwick Centre building, 2008/9 SACTA3 operational at Prestwick, 2009 Operational iTEC available on SACTA4, 2010/11 SACTA 4 operational at Swanwick AC and military, 2011/12 SACTA4 operational at Swanwick TC.

9.15 This is the type of arrangement that would exist in a competitive world where we would only expect to pay the full amount for assets that are delivered to specification and schedule. Indeed the bulk of payment would be back-loaded and subject to satisfactory user testing and acceptance. Users would avoid a situation where the bulk of payment was ahead of delivery or not subject to agreed stage deliverables. For example, when purchasing an aircraft (a complex combination of mechanical construction and software engineering) we would never pay the full amount upfront. We would only agree to pay the full amount within a framework which progressively matched payments to the progressive delivery of the aircraft to the specification agreed. The delivery of an aircraft is similar to the type of projects delivered by NATS, therefore, it would be reasonable to expect a similar payment structure between clients and supplier.

9.16 It is therefore unreasonable for the monopoly that is already insulated from market forces to be allowed to effectively increase their monopoly by not facing the consequence of not living up to expectations. In the airline industry a failure to deliver our customer service commitments to a level expected by passengers would be punished by the market. It would be anomalous for those who supply this competitive market not to experience the consequences of under delivery on their commitments.

9.17 Such an approach is consistent with the CAA's proposals for the treatment of pensions where the cost pass through needs to be subject to a 'stewardship test' to ensure users do not pay for inefficiency. The initial complexity and effort required to design such a system would be worth the effort and NATS should be given the opportunity to demonstrate their commitment to improving their performance. Also their willingness to have some macro incentives attached to the delivery of their project delivery improvement proposals would demonstrate a faith in their own systems and proposed capability improvements without unloading the risk of under-delivery onto users.

9.18 Therefore we believe it would be reasonable for NATS to accept such a payment basis for the delivery of the investment plan at whatever level it is set in the regulatory settlement. At this stage the details of the framework would require expanding and agreement. But if NATS are prepared to work within a regime that recognises them as the monopoly supplier of required infrastructure and offers protection to users (as the financers of that infrastructure) we would be prepared to consider funding the full capex plan. However, we believe the full capex plan could be funded at or very close to the price cap already proposed by the CAA given the lower cost of capital we believe is appropriate for NATS.

Consultation

9.19 The CAA is correct in noting that for consultation to be effective "users should be able to influence both the outputs they want from NATS and the priorities and timing of the required capital programme."[2]

9.20 The latest version of the SIP does set out information in a more useful way and is a step in the right direction from a presentation perspective. However, presentation does not address the issue of meaningful consultation. A macro solution to incentivise consultation would be to restrict changes in the SIP to only those that were agreed with users through the annual consultation process. This would also contribute to ensuring that capex spend was prioritised on those projects which most benefited users. The SIP should also display the output costs and benefits that are the drivers of the projects and be sufficiently transparent to allow a tracking of the outputs against these forecasts.

9.21 The recommendations of the CAA in paragraph 6.3 of supporting paper 9 are a welcome development but we think that points covering a link of the SIP projects to impacts on charges should be included in the SIP. The SIP could also incorporate a schedule for tracking the development of projects that is specifically designed to inform the framework on capex incentivisation we set out in paragraphs 9.10 – 9.18.

9.22 There is a large amount of spend on radar replacement in the SIP during the CP2 period. It is not clear if some of this relates to en-route primary radars required for military and GA use rather than by civil aviation.

9.23 The CAA should establish a timescale for NATS to improve its consultation with users and judge progress on this by a review after two years of operation in 2008.

[2] Supporting Paper 9 to CAA Initial Proposals

Treatment of Disposals and Write-Offs

9.24 We are minded to agree with the CAA that the current policy of treating disposals and write-offs be retained. However we are concerned that this should not lead to significant distortions to the RAB if assets are sold off at prices considerably below book value – for instance, disposals of computer software. In this case, the RAB could be unduly inflated by the retention of the value of assets that have been disposed of at such low prices. Users have already funded the purchase of these assets, and there is no justification for asking them to pay again to finance any shortfall in their disposal values. We should therefore welcome some reassurance that users would not suffer unduly in this respect, and evidence that there are no substantial disposals expected during the CP2 period that might fall into this category.

10.0 Cost of Capital

10.1 As we have indicated in previous submissions, we agree with the CAA's decision to employ the Capital Asset Pricing Model (CAPM) as the basis for setting the regulatory cost of capital. We also agree with the CAA's proposed adoption of a pre-tax real approach, in line with general convention and most regulatory precedent.

10.2 The CAA proposes a regulatory cost of capital for NATS of 6.5%. This is considerably greater than BA's previous estimates, as set out in our submission of 11 November 2004 "Cost of Capital for NATS in CP2", which indicated that the cost of capital should be in the range 4-4.5%.

10.3 We have reviewed our assumptions in the light of the analysis and evidence presented in the CAA's initial proposals, and in the accompanying report prepared by Price Waterhouse Coopers (PWC). As a result, we have raised our estimate of the appropriate cost of capital for NERLs' UK air traffic services business to 5-5.5%. This is still considerably lower than the CAA's proposal, which we believe is unreasonably high, and does not adequately reflect the reduced risk that NATS is exposed to following adoption of the Composite Resolution in 2003.

10.4 Under the terms of the Composite Solution, NATS faces less risk on traffic volumes by virtue of the arrangement whereby volume risk is shared 50:50 with users – and they face even less risk if the fall in traffic is especially large. In any event, airlines bear the brunt of the risk of a sharp downturn in traffic, as their initial reaction is to reduce fares in order to fill empty seats. This cuts airline revenues, while the impact on traffic volumes is much smaller. The proposed cost of capital of 6.5% does not appear to adequately reflect this state of affairs. Indeed we note that, after allowing for generic, market-wide changes in the cost of capital, the proposed cost of capital for CP2 is no lower than that adopted in CP1, despite the lower risk exposure of NATS under the terms of the Composite Solution.

In the following sections, we discuss the individual components of the CAPM.

Debt Premium

10.5 In our previous submission, we argued that the debt premium facing NATS should be around 0.5%, somewhat lower than the 1.2-1.8% used in the CAA's CP1 advice, and also below the 1.2% proposed in the CAA's initial proposals for CP2. This estimate was based on our view that the debt premium is best calculated by looking at credit default swap pricing for similarly rated UK companies. NERL is rated by Standard & Poor's at A-/Stable, which is a mid investment grade rating. CDS pricing for similarly rated UK companies suggests a range for the debt premium of 0.3% to 0.7%.

10.6 NERL is funded through a AAA rated bond, and a AAA rating would imply a lower debt premium than the 0.3% to 0.7% range. The AAA rating has been achieved through credit wrapping, but the cost of this credit wrapping is included in the accounts and therefore borne by the users. Therefore there is an element of double payment for the AAA funding as the airlines suffer a cost of capital that uses an A-rating but pay for credit wrapping to enhance the credit to AAA.

10.7 The CAA appear implicitly to agree that 0.5% is an appropriate estimate of the market's assessment of the debt premium insofar as it relates to new debt taken on by

NATS during the CP2 control period. For such debt, the CAA proposes adopting the prevailing nominal market rate for a typical A-rated company of 5.47%, which represents a real debt premium of 0.5-0.6% over the projected risk-free rate of 2.5%.

10.8 However, the CAA have taken the view that a market-based approach to assessing the debt premium is inappropriate in the case of NATS because of its high gearing, and because the inherited funding arrangements – adopted as part of the Composite Solution – involve a higher cost of debt. The CAA argue that this reflects the actual cost to NATS of raising debt at the time of the Composite Solution. The CAA's proposed debt premium of 1.2% therefore represents a weighted average of the actual cost of NATS' existing debt instruments and the market cost of new debt.

10.9 However this weighted average is pushed up considerably by the inclusion of £65,000 worth of secured loan notes at a rate of 11.3575%. As we understand it, this reflects the funding from the Airline Group, and attracts a high coupon because the loans pay out no interest until NATS generates free cash. The Airline Group does not expect to see such a return from this funding for a considerable period, and there is therefore no need for NATS to earn a return on it from the RAB during the CP2 period. This element of NATS' funding – which alone adds some 0.5 points to the weighted average of NATS' actual debt costs – should be excluded.

10.10 This suggests that the debt premium for NATS in CP2 should be about 0.7%, instead of the 1.2% proposed by the CAA. We believe that this is a more realistic reflection of the reduction in risk facing NATS following the Composite Solution, the company's improved financial robustness, and its relatively small investment programme.

10.11 We agree with the CAA that the swap breakage costs incurred in the 2003 Composite Solution should not be reflected in a higher cost of capital, as to do so would be inconsistent with the incentives that are implicit in price-cap regulation.

Gearing

10.12 The CAA takes BA to task for arguing that NATS is essentially 100% debt-financed, asserting that this is inconsistent with BA's view that NATS should bear greater responsibility and risks for its service performance. We reject this criticism. Our comment that NATS is largely debt-financed is a statement of fact, and an accurate representation of the current state of NATS' financing. Even the CAA itself acknowledges a current (2004) gearing level of about 85% (see para 9.19, CAA's Initial Proposals, Nov 2004).

10.13 We accept that a high gearing assumption may be inappropriate if NATS bears significantly more financial risk on its service performance. Therefore a substantive improvement in the service quality regime under the new CP2 price cap – one that genuinely increased the degree of NATS' financial exposure to traffic delays – might be used to justify the adoption of a lower gearing assumption. However, even then we should question the magnitude of the additional risk facing NATS, in view of the natural trade-off between traffic volumes and delays, and the volume risk-sharing arrangements introduced under the Composite Solution.

10.14 Our previous submission did not propose that NATS' gearing assumption should be 100%, but suggested a more conservative 75%. We note from the PWC report that NATS' actual gearing is projected to move from 67% to 55% over the course of the

CP2 period, with a NPV equivalent average gearing figure of 61%. We are therefore broadly content to use a gearing assumption of 61%.

Taxation

10.15 We have previously indicated our support for the notion of using an effective NERL-specific tax rate, rather than the standard rate of tax. We are therefore content with the CAA's proposals to employ an effective 'tax wedge' allowance of 20%, based on the average effective tax rate of 15% during the CP2 period.

Risk-Free Rate

10.16 We have consistently agreed with the CAA that the appropriate risk-free rate is a government 5 year bond which currently returns around 5%. To obtain a figure for the real cost of debt, it is necessary to deduct a 5 year annual inflation forecast of (say) 2.5%, thereby producing a risk free rate of around 2.5%. This is consistent with the findings of the Joint Regulators' Cost of Capital Study, as cited by the CAA in its March 2004 Initial Consultation Document.

Equity Market Risk Premium

10.17 In the 2003 airport charges review, we proposed an equity risk premium of 3.5% – lower than the 4% proposed by the CAA – and we are minded to stick with this view. The CAA's proposal is that this component of the CAPM should be rather higher than this, and should lie in the 3.5-5.0% range, using a figure of 4.5% as a central estimate.

10.18 This is higher than the assumption of 4% that the CAA used for BAA in 2002, even though 4% is equally consistent with the 3.5-5% range as the proposed 4.5%. The CAA justify this change by citing the evidence of the Competition Commission in their scrutiny of the BAA's cost of capital during the latest airport charges review. This seems opportunistic, and appears to be an example of the CAA's tendency to round the figuring in NATS' favour at every stage of the process, introducing a potentially substantial upward bias to the CAA's cost of capital proposals.

10.19 We therefore believe that the CAA should stick with the estimate of the equity market risk premium of 4% that it used in the last airport charges review.

Asset Beta

10.20 In our previous submissions, we have argued that the cost of capital should be based on an equity beta of less than unity. We still hold strongly to this view. A priori, we see compelling reasons to expect a beta of less than unity in the case of NATS – in contrast to the 1.1-1.4 range that was used for the CP1 price cap. In a regulated business such as NATS, where it is the users rather than the service provider that take most of the risk, it is difficult to see why the equity beta should be unity or above. While acknowledging that NATS has a high operational leverage, we believe that this effect is offset by the terms of the Composite Solution, which afford NERL with a considerable degree of risk protection – for instance in the form of a volume risk sharing arrangement, and a rollover mechanism for retaining operating cost

efficiencies for a full five years. This should be expected to reduce the equity beta for NATS in comparison with many other regulated utilities.

10.21 Despite this, the CAA has proposed an asset beta of 0.6 for NATS, at the top of the 0.5-0.6 range indicated by the accompanying PWC survey of comparator utilities and air transport-related bodies. The implied equity beta lies in the range 1.28-1.54.

10.22 This range is high compared with the estimates quoted by PWC for comparator businesses. For instance, the implied equity beta is far above that of the airlines themselves, who are widely acknowledged as facing considerably greater risks than NATS. Even the asset beta, which makes allowance for the risk arising from NATS' high gearing levels, is no higher for airlines than the 0.6 proposed by the CAA. We therefore do not see how the survey of comparator businesses leads to the conclusion that the range for the asset beta should be as high as 0.5-0.6%.

10.23 The CAA then compounds this bias by adopting a figure of 0.6% - at the very top end of the range - producing an implied equity beta of more than 1.5. This seems excessively high for a regulated business such as NATS. We therefore re-iterate our view that the equity beta should be less than unity.

We agree with the CAA's decision not to incorporate a small company risk premium.

Overall Approach and Degree of Risk

10.24 Our estimates of the components of the CAPM approach- with an illustrative (and conservative) assumption of an equity beta of 1.2, equivalent to an asset beta of 0.5 - are summarised in the table below. On this basis, we conclude that the real pre-tax cost of capital for NATS should lie in the range 5% to 5.5%. This is a full percentage point lower than the CAA's proposed cost of capital of 6.5%.

	CAA CP1	**CAA CP2 proposals**	**BA proposals**
	Jan 2001	*Nov 2004*	*Feb 2005*
Risk-free rate	3.5-3.8	2.5	2.5
Debt premium	1.2-1.8	1.2	0.7
Gearing	0.5	0.61	0.61
Equity beta	1.1	1.54	1.2
Tax rate	0.15	0.15	0.15
Equity risk premium	3.5-5.0	4.5	4.0
Cost of capital (pre-tax, real)	7.75 (7.0-8.7)	6.5	5-5.5

10.25 Our main points of disagreement with the CAA relate to the assumptions for the equity beta and the debt premium.

10.26 Even aside from these differences, we observe that the CAA have rounded up the cost of capital from the 6.1% suggested by the PWC analysis, to 6.32% by adopting an asset beta at the top end of the range, and then to 6.5% for no apparent reason. Indeed we observe that the CAA appear to have taken the opportunity to round the figures upwards – in NATS' favour - at every stage of the process, introducing a significant element of upward bias into the proposed regulatory cost of capital.

10.27 The proposed reduction in the cost of capital from 7.75% in CP1 to 6.5% in CP2 – a decline of 1.25 % pts – is almost entirely accounted for by the lower risk-free rate. This is a generic component of the CAPM, and reflects the decline in UK real long term interest rates that followed the transfer of control over interest rates to an independent Bank of England in 1997. In other words, the reduction in the proposed cost of capital since CP1 has nothing specifically to do with the circumstances of NATS. And yet by common consent the risk facing NATS has been significantly reduced by elements of the Composite Solution, especially the volume risk-sharing arrangements. This indicates very strongly that the CAA's proposed cost of capital is too high.

11.0 Oceanic Price Control

Design of the Control

11.1 We agree with the CAA's intention to retain the RPI-Z form of price control.

11.2 The Oceanic price control does not have a volume risk element in contrast to the 50% fixed allowance and 50% volume related allowance for Eurocontrol. We do not think the CAA should strive for consistency between the Oceanic and Eurocontrol price controls unless it is objectively merited. Therefore we agree with the CAA's proposals to continue with the current approach of revenues being 100% driven by Oceanic flights.

11.3 We support the CAA's proposal to apply any correction to allowed revenues one year, rather than two years, in arrears. With adjustments over longer periods there is a danger that costs and revenues would be out of line in any particular year. This is a situation that should, as far as possible be avoided due to the complexity it could bring to annual charges consultations and the unanticipated consequences to users of not being able to budget for the latter years of CP2 as accurately as possible. A one year correction time is in keeping with user's preference to pay for services as close as possible to the time of consumption.

11.4 The CAA is correct in stating that the two dimensions of service quality for Oceanic services are track and flight level. Whilst we do not think it necessary to attach an incentivised quality framework to these metrics at the moment, they should continue to be reported so the users can take a view of trends in the level of service provided.

11.5 We agree with the CAA proposal to continue to base the charging condition on the NATS financial year (April – March).

11.6 In addition to the points above we believe the CAA should give consideration to a mechanism that offers incentives for operations with ADS/CPDLC equipped aircraft. ADS equipped aircraft mean that HF communications are no longer required, allowing opportunities for cost savings in the Oceanic service. Nav-Canada already offer reductions for ADS equipped aircraft and such a system should be implemented for NERL's Oceanic business.

Traffic Forecasts

11.7 Our comments on the Oceanic traffic forecasts are covered in Chapter 6 where we indicate our broad agreement with the CAA's forecasts.

Opex

11.8 Since operating costs make up 90% of the cost base of Oceanic it is the most important dimension of the regulatory settlement. NERL has outperformed the forecasts used by the CAA to set prices in CP1. This indicates both that NATS is capable of finding savings and that the RPI-Z regulation has produced the savings it is designed to incentivise. The CAA should not consider the one-off payment of £11.8 million made by NERL as contributing to the operating costs.

11.9 As we have argued earlier, we see the CAA's estimates of the scope for efficiency improvement as realistic and not unduly stretching, and would question the

assumption that wage and pension increases are allowed to offset efficiency improvements. Given the capacity of NERL to find efficiencies in CP1, we believe the CAA targets should be achievable without a serious risk to service quality and operational effectiveness.

Operation of the Rollover Mechanism

11.10 If the one-off £11.8 million payment is not included in the opex costs it follows that the savings made between the payment year and the following year should not be considered as special savings for inclusion in the rollover mechanism. The mechanism suggested by the CAA to allow NATS to benefit from the incentive properties of the rollover mechanism appears to allow NATS to keep the benefits of efficiencies for more than 5 years. As we have noted in paragraph 8.12, it is important to ensure that the adjustments to the RAB in subsequent price control periods are fully transparent and that the incentives on NATS to make operating efficiency gains are not watered down under the rollover mechanism. In particular, the unwinding of the 5 years of savings should be visible to users with dynamic reductions in the RAB and therefore airport charges over the course of CP2. Also, it should be clear to users that the savings achieved through the rollover mechanism are in addition to those incentivised through a standard opex efficiency target.

Capex

11.11 We welcome the initiative by the CAA to reduce the capex allowance by 80% as a protection for users from higher charges for investment that might not be delivered. However, given that the investment serves the operational requirements of users we would prefer to have a system which rewards the delivery of investment to agreed schedule and scope specifications. We believe that the type of framework we propose for Eurocontrol investment should be replicated for the Oceanic investments.

Cost of Capital

11.12 We agree that as the Cost of Capital is based on parameters that relate to NERL as a whole we see little merit in attempting to differentiate between the Eurocontrol and Oceanic parts of the business. Therefore our comments on the Cost of Capital for Eurocontrol also apply to the Oceanic business of NATS. In summary we believe the appropriate Cost of Capital should be in the order of 5 – 5.5% for the reasons we set out in Chapter 10.

APPENDIX 1

Comments on PWC Paper on Procurement Effectiveness

General – Overall strategy proposed is welcomed and certainly a step in the right direction. To ensure effectiveness of the strategy and process there must be a robust prioritisation mechanism to enable best value to be achieved out of the projects that really deliver benefit to NATS and its customers.

Many major projects scheduled for delivery during the CP2 period are heavily reliant on IT for their successful implementation. We stress the importance of having the resources that possess the commensurate skills and experience to procure and contract manage third parties to deliver complex IT developments and services to specification, timescale and budget. Furthermore it cannot be stressed that the procurement processes to support major change programmes should be designed to ensure that there is an effective change control process to monitor and control creeps in cost, scope, specification and timescale.

Care should be taken with the 'quick wins' approach to ensure that these do not undermine larger longer term benefits that could be realised as a result of taking a more robust approach following strategic sourcing principles.

Comments on Recommendations.

a. We welcome the principle that NATS has set some goals in the form of vision statements. However an action plan of 28 deliverables could result in diluted focus.

b. There is however insufficient thought at this stage as to how success will be measured. What methods of measurement and metrics will be used for each vision statement to enable an independent third party to establish how successful NATS have been in each key area of procurement.

c. There are many known parameters with regards to the size and complexity of the procurement programme over CP2 in order to support the OPEX and CAPEX needs of NATS. However despite clear thinking on the way forward with regards to strategy and process it is surprising that there is little thought to the quantity of procurement professionals required. The figure of 150 "NATS customer and procurement staff" is quoted in section 3.3 of the document. We would be concerned if the resourcing was either over or under necessary requirements to ensure that procurement needs were delivered. As a benchmark, to deal with approximately £ 3 billion of external spend, through a strategic sourcing programme British Airways delivers this through 150 procurement staff engaged in both buying and support roles. Therefore for external spend of £ 1 billion pa we would expect NATS to require far fewer people to deliver their programme.

d. *Strategic Sourcing Workstream* – Paragraph 1. It is important that the work that NATS procurement undertake on priority projects is fully integrated with the overall project management programme within NATS. Experience at BA with strategic sourcing leads us to advise NATS to ensure this workstream is fully integrated with the Processes workstream as the processes are the tools to deliver strategic sourcing.

e. *Paragraph 3* – We consider that against an external spend plan of £ 1billion savings of £ 10m in 05/06 and £ 15 m in subsequent years is not sufficiently stretching. As an example British Airways has had stretching targets to save through Procurement approximately £ 90 million year on year against a baseline of £ 3 billion external spend.

f. *Systems & Tools Workstream* – Paragraph 5. We recognise that the external data sources are valuable in supplier comparative , however would like to draw attention to the fact that these alone are usually not sufficient and processes involving Request For Information (RFI) or beyond to Request For Proposal (RFP) may be required.

g. *Measures of Success* – The specific metrics agreed should link to the vision and objective statements cited earlier in the document in section 4 Recommendations, such that NATS can be satisfied that these have been achieved as a result of the agreed measures. Furthermore it may be prudent to use qualitative research with suppliers and staff to help judge whether the vision statements have been achieved.

Appendix 2

Comments on KPMG Paper on Benchmarking the Corporate function costs of NATS

Detailed Comments on the KPMG paper

Project Overview – Overview and approach

The KPMG study has excluded any of the central functional costs that are there to support the front line business. It is understandable that the front line operational part of NATS itself is unique in comparison to any other UK business, however the actual central functions that support these areas may not be drastically different from any other business which has a central function to support a front line. Therefore focusing only on central services that support the back office functions potentially excludes an opportunity as part of this benchmarking study. For example, finance personnel and practices supporting the ATC business may not really be radically different from those supporting back office areas.

Workstream Review – Finance

Key Activities / processes

Most large organisations undertake a change or improvement programme of some form during a financial year. It is noted that KPMG have chosen to exclude the cost associated with NIBS as these are included in IT costs. We trust therefore that costs of participation in similar change programmes by organisations making up the benchmark data have been identified and apportioned appropriately to ensure like for like comparison.

Benchmark Comparators

We note that the finance benchmark data relates to 2002 at latest. The NATS data used to compare is from 2002 up until 2004. Given the NATS data shows some substantial changes during this period (e.g. 19.6 % cost increase between 03 /04 and 04 /05), there is some concern that we may not be making like for like comparisons as the benchmark data may also have had some significant changes in either direction since 2002.

Furthermore the benchmark data uses US and other European data, but the tiering of the benchmarking is in GBP. Given exchange rate and production cost differences in other countries, can we be certain we are making similar comparisons. It would be useful to understand if a purchasing power parity or other approach had been followed to deal with costs between different countries.

Staff Costs

The closure of other sites around the UK and integration of functions into CTC would seem to give the opportunity to re-base salaries at the median for any new recruits that are required to backfill vacancies created as a result of wastage.

It is evident that salaries are already high in comparison to the median. Whilst this may be an explanatory factor of the existing situation we note the KPMG have identified that NATS are not seeking to address this and indeed appear to be planning for RPI + wage settlements over

time despite a high starting baseline. It is of concern that there are no plans to bring such costs more into line with the market.

Workstream Review – IT

NATS have deferred spending on NIBS pending an acceptable business case for the next phase. Given the current regulatory treatment of OPEX, we would be concerned if there was any OPEX attributed to NIBS that is not spent on activity it was budgeted for and users have already paid for through the unit rate.

Range of Applications.

We note that KPMG identified NATS support fewer processes than other companies in the benchmark and would expect that this part of the business may therefore be less complex

Benchmark comparators

The UK data used is 2003 figures, but NATS figures for up to 2004/05. Similar concerns as raised with the Finance section about like for like comparisons due to observed changes in NATS expenditure over time.

Workstream Review – Facilities Management

Key Activities and Processes

It is difficult to understand how many of the '*Expenditure items'* in this section are not easily benchmarkable and therefore out of scope. Such purchases are not unique to NATS or the ANSP business. For example office supplies and stationery, printing and vehicle charges.

Cost Analysis

We note that KPMG recommend further benchmarking on facilities team staffing cost as the current data set is management staff only and does not comprehensively reflect the entire function.

Facilities function efficiency

Note that NATS have no formal plan to address staff or functional efficiency over the next planning period.

Conclusions

A number of procurement opportunities have been identified in the KPMG paper for the facilities function. Given a wholesale strategic sourcing change programme is underway, as identified in the PWC report, we would expect the vast majority of the efficiency gap in these contracts to be achieved as a result of the investment in strategic sourcing.

Appendix 3

Comments on Solar Alliance / Steer Davies Gleave on Cost Benchmarking NATS relative to selected ANSPs

It is appropriate that the PRC benchmarking data has been used as a starting point for this study undertaken by external consultants.

The comparative set of ANSPs have been chosen partially on the basis of relatively similar unit labour costs. This is potentially flawed because it may be looking at a control group who all exhibit similar high labour cost problems. We do recognise that business complexity has also been taken into consideration in the selection of the comparison group.

The CAA relies on the fact that NATS ATCO productivity is significantly better than other European ANSPS in section 7.24 of the main CAA paper. Whilst this is a correct statement, the Solar Alliance/Stear Davies Gleave consultants report does highlight that the ATCO productivity is inflated as a result of the support work done for them by ATSAs who then add to the total cost of NATS. It should also be noted that the latest data shows this productivity gap between NATS and other ANSPs is closing.

In 7.26 of the main paper it is stated there has been overstatement of costs of NATS in relation to other European ANSPs. This is true, but it must be pointed out that the consultant's report identifies that there are areas of cost where other ANSPs, currently more costly than NATS, have also had costs overstated. Such an example is CNS infrastructure costs borne by LVNL and Belgocontrol.

The Solar Alliance paper identifies that in considering gate to gate level costs NATS is 22 % higher than average. If operating costs only are considered – which specifically excludes capital related costs and exceptional items – then NATS costs are reasonable to the benchmark. It must be stressed that the user does have to take all costs into account, as these have to be paid for through the unit rate. It must also be borne in mind that the regulator has influence over certain capital costs through the cost of capital set.

The main CAA paper attributes ATSA costs as a significant driver of high support costs. Whilst this may be the case, the KPMG paper, which focused solely on non-operational support areas, highlights inefficiency gaps of between 17 and 28 % over CP2. Therefore ATSA costs cannot alone explain a high support cost ratio.

The consultants do conclude that due to the price regulated environment that NATS operates within, far more onerous than its comparators, NATS should achieve a better than average cost performance. Therefore it is reasonable to conclude from this that there is scope for improvement.