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28 September 2012

Dear Richard

**RESPONSE TO CAA'S CONSULTATION ON RP2 ECONOMIC REGULATION PROCESS UNDER THE SINGLE EUROPEAN SKY**

1. I am pleased to enclose our response to the CAA's July consultation document on the RP2 economic regulation process under the Single European Sky.
2. This letter sets out our key points. More detailed points are included at Annex A.
3. In this response the term NATS refers to the NATS Group including:
  - NATS (En Route) plc – NERL, which is economically regulated
  - NATS (Services) Limited - NSL, which is not economically regulated.
4. We welcome the CAA's early consultation on this subject given the importance of aligning the EU and UK regulatory processes for RP2.

**Context**

5. NATS supports the overall objective of the Single European Sky of improving European ATM performance. A European wide economic framework for ATM now exists alongside the UK economic regulation framework established under the 2000 Transport Act. We note that the CAA considers that these two regimes can co-exist without conflict providing the PRB and CAA work closely together to assess the reasonableness of targets for NERL. NATS believes that providing an objective, economic and evidence led approach is taken by both EU and UK regulators on RP2, it should be possible to achieve an outcome that is acceptable to all stakeholders and which makes a material contribution to the achievement of the Single European Sky objective.

## Price reduction targets in RP2

6. NERL acknowledges the importance to customers and regulators of real price reductions in RP2. Pending the confirmation of the EU-wide targets, NERL has launched a programme of work to include the CAA real price reduction scenarios of 2% p.a., 3.5% p.a. and 5% p.a. in the company's draft RP2 Business Plan alongside its recommended scenario to provide the best value for customers. This will form the basis of the consultation with customers after the end of March 2013.
7. NERL is approaching the scenario work objectively and with an open mind. It will explore all means needed to achieve these levels of price reduction. As requested by the CAA, NERL will set out what it would need to do to achieve these scenarios and will also assess the likely impacts, especially in relation to safety, continuity of service, capacity, and the ability of NERL to finance its licence activities. While NERL will explore all means available of limiting the effect of price reduction on service, the company expects that the greater the price reduction the greater the impact on service. The company will not support price reductions which could have the effect of reducing safety below required levels.
8. NERL looks forward to engage constructively with airline customers in 2013 to understand their priorities and explore the potential benefits, costs and risks of the CAA's scenarios to inform target setting and the revised RP2 Business Plan required by the CAA in the second half of 2013.

## Targets should be both challenging and achievable

9. NERL understands that the price target scenarios will be used to inform the setting of regulatory targets for RP2 and should not, at this stage, be viewed by stakeholders as the regulatory targets for RP2.
10. When the regulatory targets are actually set, whether at EU or UK level, it will be essential to ensure that they represent an appropriate balance between the need to be challenging and the need to be achievable. We believe that achieving this balance is in the interests of both NERL and its customers: if targets are too weak then customer interests will not be furthered; if targets are unachievable then there will be consequences for service that could equally undermine customer interests.
11. NERL understands that economic regulators have a duty to promote efficiency and economy, and will respond positively to this challenge. The company has no doubt that DUR reductions of -2% p.a., -3.5% p.a. and -5% p.a. are challenging because they would respectively require cumulative real reductions of -9.6%, -16.3% and -22.6% in determined unit costs, assuming that RP2 is set for a 5 year period. The schematic at annex B sets out the principal building blocks of the CP3 regulatory settlement. This illustrates the challenging nature of these targets even before taking account of new (and likely reduced) traffic forecasts and the proportions of cost that are directly under the control of NERL and those which are subject to market factors.
12. The actual regulatory targets will also need to be achievable recognising the following factors:
  - Customer requirements for service
  - EU requirements for investment in SESAR, including UK requirements for investment in FAS where there is identifiable customer benefit in doing so
  - Legal obligations of the CAA under the 2000 Transport Act e.g.
    - i. to further the interests of airspace users

- ii. to ensure that NERL will not find it unduly difficult to finance its activities authorised by the licence
    - The assessment criteria in the EC regulations
    - The principles of better regulation
    - Existing regulatory obligations in relation to incentives/penalties and/or true-ups (either way) that would be required to be recognised in the RP2 settlement (e.g. rolling incentives for efficiency; investment and pension costs)
13. Fulfilling these requirements and obligations will involve robust analysis and an evidence led approach in relation to key inputs such as:
- Latest traffic and inflation forecasts
  - Fixity and elasticity of cost
  - Nature and extent of cost efficiencies already achieved
  - Market driven costs (cost of capital and pensions)
  - Airspace complexity
  - Costs of change and the achievable payback periods
  - Regime which genuinely incentivises performance and is not punitive
  - Manageable risk

#### **An objective, economic and evidence led review**

14. Previously, the CAA has taken an objective, economic and evidence led approach to setting NERL's price controls. In particular, NERL recognises that the CAA has focussed on assessing the level of efficiently incurred costs that are required to meet customers' service requirements. This approach has been informed by a rigorous and objective assessment of NERL's business plan and relevant benchmarking data, for example from the ACE performance report. NERL believes this approach provides the most appropriate basis for reaching judgements about EU and UK target setting.
15. NERL also supports the EC's plan to conduct studies on pensions, cost of capital and interdependencies and encourages the CAA to actively contribute to those studies. On the basis that these studies are rigorous, they should provide relevant and meaningful information to inform target setting.
16. NERL has noted the attention paid by some stakeholders to the European En Route unit rate league table. Consequently, NERL perceives a risk that the UK could come under considerable pressure from some stakeholders to make reductions in price with reference solely to that unit rate league table.
17. NERL believes a simplistic comparison of price does not provide a like for like and robust basis for benchmarking or for informing target setting. With the exception of NERL, all ANSPs in this table are State owned and the table reflects the underlying costs and returns including for example many different State supported pension and funding arrangements. Rankings in the table are also influenced by market driven exchange rates. Under the PPP arrangements, except as provided by European regulation (e.g. State aircraft) NERL is expected to recover its efficiently incurred En Route costs (as determined by the Regulator) only from its airline customers without any State contribution.

18. Once NERL's pricing reflects customers' reasonable requirements and an efficient level of costs (whether controllable or otherwise), then any calls by customers for further reductions in the UK unit rate would logically represent a call for financial support from the UK Government.
19. On the basis that the approach to RP2 by all stakeholders, including EU and UK regulators, remains objective, economic and evidence led, NERL believes a mutually acceptable outcome for all stakeholders can be reached. Such an outcome would avoid the prospect of RP2 being disputed through mechanisms contained in relevant legislation. In the event that NERL concluded that the outcome of RP2 was not objectively justified, the company would have to consider seeking appropriate forms of redress, starting with the UK Competition Commission.

### **Other contributions to the UK unit rate**

20. NERL's determined costs represent c.85% of the UK unit rate. While NERL expects its contribution to the unit rate to receive the most of the scrutiny for RP2, there are a number of other parties whose costs contribute the remaining 15%. As the DfT and CAA consider how the UK should contribute sufficiently to the EU-wide cost efficiency target, NERL presumes that they will seek commensurate contributions from these other parties.

### **Costs of regulation**

21. NERL also notes that the direct and indirect costs of regulation – both at a national and European level – are significant, and in some cases increasing with the creation of new agencies and regulations. NERL believes that these costs should be separately identified and justified both at a UK and European level to ensure the regulatory requirements are justified by the benefits and that the costs are efficiently incurred.

### **FAB targets**

22. NATS recognises that FABs are a key pillar of Single European Sky and is committed to working with its FAB partner to deliver operational, environmental and cost efficiencies for its customers.
23. While FABs provide one mechanism for enabling performance improvement, they are not the only means and there may be better alternatives for securing some aspects of performance improvement. Accordingly, FAB plans should be designed to accommodate this principle and give ANSPs the freedom to pursue alternative delivery mechanisms where relevant.
24. NATS accepts that it may be appropriate to set some joint FAB targets, although only where doing so offers tangible benefits and clear accountability for performance. In particular, NATS does not support FAB-wide cost efficiency targets/charging zones or a FAB-based approach to airport targets.
25. It is important to recognise that FAB arrangements attract growing regulatory and ANSP costs. Therefore, any extension of the existing arrangements should provide tangible benefits to customers in excess of these increased costs.

## **Customer consultation**

26. Following constructive consultations with customers in 2009, NERL supports the early and upfront consultation with customers on NERL's draft business plan, including the CAA's scenarios, starting in April 2013. Such consultation will provide important insights into the relative value that customers place on service and price which will inform the approach to target setting in RP2 and enable NERL to present a revised business plan in Autumn 2013.
27. However, NATS believes for the benefit of all parties this consultation needs to be efficient and focussed on the main considerations relevant to reaching a well-considered conclusion to RP2.

## **Extension of RP2 Airport ATM**

28. The existing SES regulations extend the Performance Scheme in RP2 to terminal ATM services at airports with more than 50,000 civil ATMs per annum. NATS believes that it will be important to implement this extension in a way that is proportionate to the potential benefits and added value and reflect the divergent nature of airports included within the scope of the regulation.
29. NSL welcomes the CAA's early consideration of how this should be achieved, particularly the early completion of the contestability review of the UK market. This will be key to informing how the regulation is applied to terminal ATM in the UK.
30. Irrespective of the outcome of the contestability review, RP2 will extend capacity, safety and environmental targets to terminal ATM. NSL's strong view is that these targets are most appropriately applied on a bottom up rather than top down basis because:
  - Metrics for the quality of service performance of terminal ATM are less mature than for En Route services
  - A number of key parties heavily influence airport ATM performance, including the airport operator (who owns and controls ground infrastructure and ATM assets), the airline, the airport scheduler as well as the ANSPs. Currently, the performance regulation applies only to ANSPs
  - The operational dynamics of each airport are different. Applying simple top down targets could create unintended consequences and undesired behaviours, e.g. a target to improve delay performance at capacity constrained airports may lead to a reduction in the airport schedule.
31. NSL looks forward to working with the CAA, airport operators and other stakeholders to ensure RP2 is implemented in a proportionate and sensible manner that meets the requirements of all stakeholders and makes tangible steps towards achieving a genuine gate-to-gate approach to service delivery.

## **Regulated NERL En Route Services outside SES**

32. NERL believes that the monopoly En Route services for Oceanic airspace should continue to be subject to economic regulation. However, we agree there should continue to be a strong emphasis on a simple and proportionate design for that regulation.



## Conclusion

33. NATS supports the overall objective of the Single European Sky of improving European ATM performance. It acknowledges the importance to customers and regulators of real price reductions in RP2. Provided there is an objective, economic and evidence led approach to setting targets both at EU and UK level, NATS believes a mutually acceptable outcome for all stakeholders can be achieved. The company looks forward to working constructively with all parties to this end.

34. We look forward to discussing these issues at the CAA's workshop on the RP2 process on 15 October.

Yours sincerely

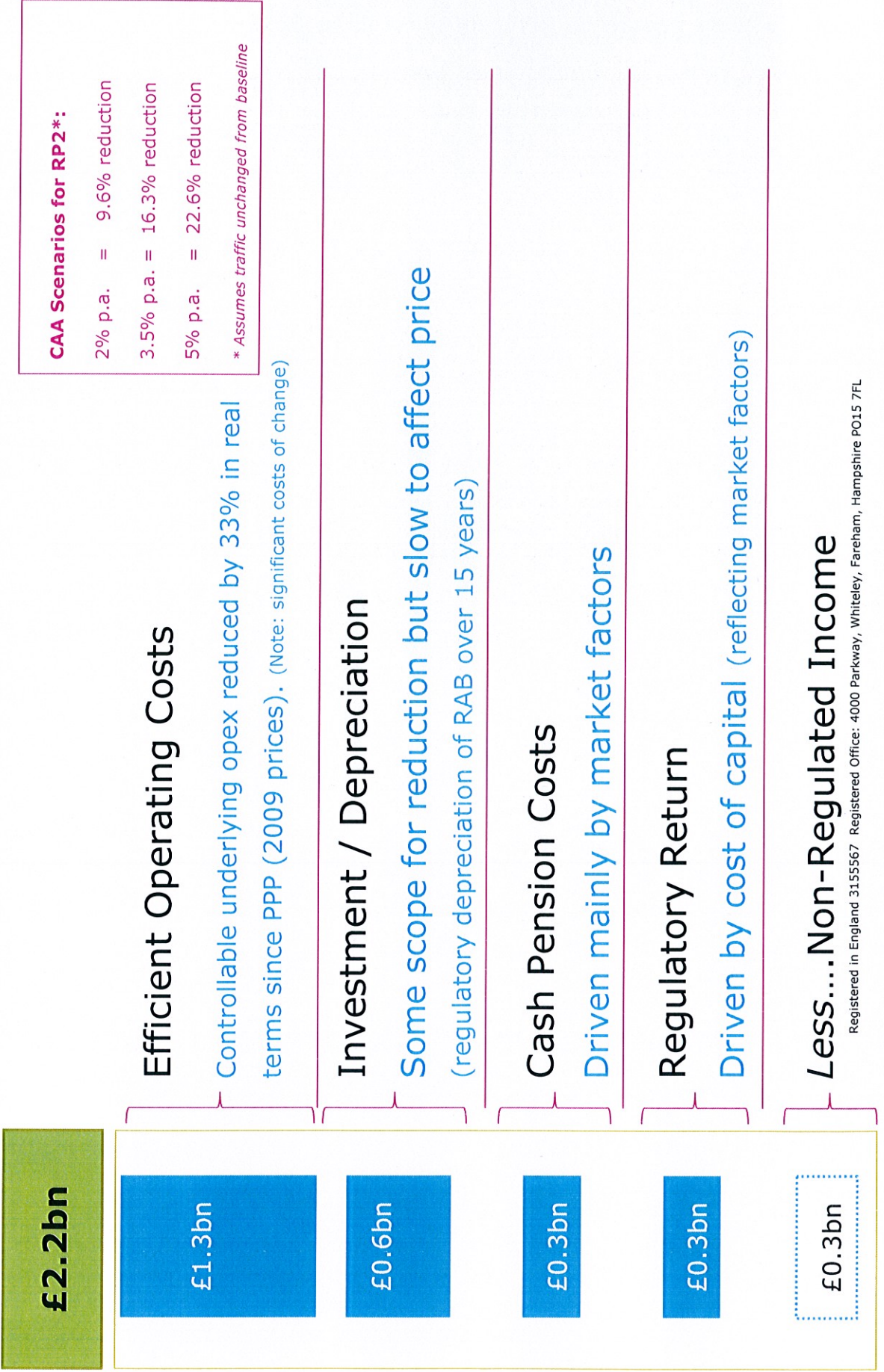


Tim Johnson  
Head of NATS Regulation

**Annex A: further detailed comments**

<b>CAA condoc para</b>	<b>CAA proposal</b>	<b>NATS comment</b>
Para 3.4	CAA/IAA SRD considering possibility of creating joint accountability for a single capacity target	NATS supports consideration of this possibility, providing the service benefits of such an approach outweigh the additional costs/complexities of managing this jointly.
Para 3.4	CAA to review vertical/horizontal metric with a view to enhancing NERL's RP2 performance and possible extension to Irish airspace.	NERL believes that both the vertical and horizontal aspects of a flight are important in assessing overall flight efficiency. As such, NERL supports CAA in continuing to apply this approach in the UK and encourages the CAA to persuade the EC to include both dimensions in any revision to the performance regulation.
Para 3.4	CAA believes it is unlikely there will be a common charging zone and cost efficiency target.	NERL strongly supports the CAA's proposed approach.
Para 5.8	CAA may consider financial incentive Mechanisms to encourage delivery of programmes such as SESAR, FAS and LAMP.	NERL believe it will be important to ensure that any proposals for SESAR, FAS and LAMP should be based around the benefits they can deliver to customers. While NERL would consider carefully any CAA proposals for the strengthening of NERL's incentives to deliver certain FAS initiatives, it would be concerned to ensure that these lie fully within NERL's control and are not reliant on third party co-operation. Further, it would be important to ensure that any investments NERL is required to make are financeable.
Paras 6.3 to 6.7	CAA will review capacity and environmental incentives for RP2.	NERL supports the retention of financial incentives/penalties for improved delivery of key customer service priorities.
Para 6.14	CAA may consider incentive schemes for en-route users	NERL supports the CAA in considering how to create the right incentives for all parties to improve their contribution to efficient use of airspace. The potential benefits would need to be assessed against the range of potential challenges and complexities involved with its introduction.

## CP3 Net Revenue Requirement (2009 prices)



**CAA Scenarios for RP2\*:**

- 2% p.a. = 9.6% reduction
- 3.5% p.a. = 16.3% reduction
- 5% p.a. = 22.6% reduction

\* Assumes traffic unchanged from baseline