UK – Ireland FAB Performance Plan for RP2 (2015-2019)
Airline Community Response

Introduction

We welcome the opportunity to comment on the UK-Ireland FAB Performance Plan for RP2 and we are pleased to submit a consolidated Airline community response to this plan. This response represents the collective views of the Airline community in the UK and Ireland and has been endorsed by the carriers and representative trade bodies listed in Appendix 1. We are confident that it has been sourced from an airline community engagement process that has given all carriers the opportunity to participate and comment. It also provides an excellent cross section of views from the airline community and reflects full service carriers, overseas carriers, and low cost operators from both UK and Ireland.

Whilst there are clearly some differences between the opinions of the airlines and NATS on their final business plan, and on the level of challenge made by CAA in some areas, the airlines acknowledge and welcome the efforts of both NATS and CAA in engaging in a broad consultation of their plans.

In contrast, the community has been disappointed that a similar approach has not been taken by the IAA either on the ANSP plan, or the FAB plan. Opportunities to engage constructively and contribute actively to the plan with priorities and constructive feedback have not been available to Irish carriers or more widely to other users of Irish Airspace. The community would welcome more opportunity to be involved with IAA consultation on next draft of the Plan, and we would strongly encourage the IAA to benchmark the UK consultation process of the CAA and NATS for RP3.

The lack of consultation, and detailed information on the Irish element of the FAB plan, is reflected by the significant weighting of this response towards comment on the UK CAA element of the plan. This should not be taken as a lack of importance being placed on the Irish plan, but that the CAA plan offers more opportunity and material on which to comment.

This disparity in the extend of consultation and ability of the airlines to comment upon the Irish element of the plan, is perhaps reflected in the fact that it is the community's view that the RP2 Performance Plan does not reflect a cohesive joined up plan for the FAB. It reflects a collective of different methodologies and factors and lacks coordination on some aspects of bonuses and metrics. No more is this highlighted than in the IAA's development of a contingency centre at Dublin during RP2, without any consultation with NATS over the potential use of existing UK centres at Swanwick and Prestwick. We recognise that costs in Dublin would most likely be lower, so alternatively had discussion taken place, proposals could have been made for NATS to consider using a centre in Dublin instead of Prestwick.

The views contained within this response build upon those previously expressed to CAA in recent meetings. We hope that our response is comprehensive and readily understood, and we are available at any time to discuss any of the points raised with the CAA / IAA to provide additional clarity.

We highlight however that this response is written on the basis of the RP2 plan as it currently stands and the information available at this time. The community retains the right to revise or add to its submission should additional information become available at a later stage.

To assist the CAA and IAA in considering the Airline community response we have followed the outline structure of the RP2 Performance Plan against which to comment.

Executive Summary

The community recognises the efforts of the CAA within the RP2 plan, to rectify some of the shortfalls in performance and cost challenge within the previous Control Period. There are still significant areas where more challenge is required.

- The CAA has continued to build on the RP1 performance measures that were put in place to recognise those aspects of performance that were most important to the airline community.

- The targets on most performance measures are now more reflective of actual and achievable performance than those set for RP1. This will continue to help ensure that performance improvements are delivered for the benefit of all passengers.

- Conceptually targets for TANS performance are very positive, but the targets themselves require further refinement to make them meaningful.

- The use of incentivisation to provide impetus to deliver critical projects on time is a significant and very welcome response to the community's feedback over the past regulatory cycle.

- We are supportive of the level of scrutiny of the NATS RBP opex proposals that appears to have been made by CAA for RP2, and there is evidence that CAA has correctly identified a number of elements to disallow from the plan.

- The CPI cap on pay is welcome but does not go far enough to address the current and future pay levels of ATCO's. We urge CAA to review and act on the current structure of the ATCO labour market.

- CAA has not taken strong enough action to limit the liability on pensions to that of a competitive entity. We expect a maximum pass though of a 20% contribution rate in line with the LHR determination.

- We recognise the direction of travel for the WACC as being in the right direction, but the proposed level does not reflect the significantly lower risk of NATS than airports.

Taking into account many of the points made above and action that the CAA has taken in the plan, the airlines have used their model to create an updated price path that we believe delivers a price that is in passenger interests and that the CAA can reasonably expect NATS to deliver over the RP2 period.

The model which has been created by the airlines uses a base for their modelling of the NATS business plan. This has then been updated with updates to the following areas:

- WACC = 5.2%, which we consider a reasonable assumption based on NATS risk
- Opex updated as discussed with capped pension costs and CAA removed contingency costs
- Capex = 10% efficiency on cost of projects

Using the airline modelling detailed above, a price path of 31% over the RP2 period is demonstrated to be achievable. We believe that taking the suggested actions, over and above those measures already addressed in the CAA plan, is not only reasonable, but fundamentally within the CAA's duty towards efficient opex.
We would be happy to talk the model through with appropriate CAA staff if you wish to discuss this work with us.

FAB Safety

There is complete agreement from the Airline community with NATS and the IAA on the paramount need to consistently deliver a safe operation.

Airline representation on the UK/Ireland FAB Management Board has enabled the airline community to appreciate the excellent work being undertaken at a FAB level in terms of SMS harmonisation, Safety Culture and Operational Safety Improvement.

We do feel however that the RP2 Performance Plan must be stretching in this area and must build on the high safety performance we recognise as already being delivered by both NATS and IAA.

Our view is that with a mature and stable system already established in both UK and Ireland that there is no reason why targets should not be more stretching, particularly given the often stated intent of NERL to strive for continuous improvement in Safety. We therefore propose that the following targets be adopted by both CAA and IAA for their respective ASP's.

1. Effectiveness of Safety Management (EoSM)

Under Level D we note that targets should be managed and measured and reflect that objectives are used to manage processes and performance. We believe that the descriptor of this level of Safety management is already broadly reflective of what the community observes to be in place. The CAA should therefore consider whether it would be appropriate to add a target to achieve a D/E level by the close of RP2.

2. Risk Analysis Tool (RAT)

As EU wide targets are being met or exceeded in this area we consider the Performance Plan reflects the right level of aspiration for the RP2 Performance Plan in Separation Minima Infringement (SMI), Runway Incursion (RI) and Air Traffic Management Specific Occurrences (ATM-S) targets.

3. Just Culture

The Airline community fully supports the Just Culture programme but we are concerned in two areas of what is currently proposed.

Firstly, there is in our view, a lack of definition on what is meant by 'demonstrate progress '. This will inevitably lead to difficulties assessing the success of reaching this target, and therefore impact the meaningfulness of the measure.

Secondly, and most importantly, we believe that given the importance of Just Culture in promulgating safety, that a simple target of 2019 for 100% of identified staff to be trained is insufficient.

This belief is in terms of a suitable time period for the training of all identified staff to take place. Just Culture is not a new concept to aviation, and has been widely introduced across airlines for many years. As a benchmark example, Just Culture has existed within British Airways for at least 20 years. We therefore anticipate Just Culture training should already have been commenced within NATS, and training should not need to be started from a zero position. We believe that targeting a completion date of 2017 is achievable and more appropriate.

In addition, taking on board the comments of the CAA panel, we recognise that simply completing the training of staff is not indicative of Just Culture being in place. We would therefore propose that an additional quality measure is introduced alongside a 2017 target for 100% training. As examples, this could take the form of evidence being provided of suitable processes for managing (i.e. reporting, evaluation and action) and promoting Just Culture, and commitments to Just Culture from the highest management being made and visible throughout the business.

With both quality and timing measures in place, we feel that the argument that more challenging targets would induce the wrong behaviours on quantity over quality of training would be negated.

FAB Environment

The Airline community is supportive of the performance measures that consider both horizontal and vertical trajectory components. We therefore endorse the UK's adoption of horizontal en-route flight efficiency of the actual trajectory (KEA) target at a FAB level. The EU target adopted as the FAB target for RP2 is acceptable to the Airline community.

The changes to UK airspace as a result of the major redesign of LTMA airspace under the LAMP programme and in the Northern Terminal Control Area (NCTA) are critical to the future efficiency, capacity and performance of UK airspace, and these will underpin the delivery of the KEA performance targets in RP2. We welcome the CAA's recognition of the airline's stated desire throughout the RP2 process, to see greater accountability of NERL for delivering these key programmes on time.

We are therefore fully supportive of the CAA's intent to hold NERL accountable for the delivery of key elements of the Future Airspace Strategy (e.g. LAMP and harmonised TA) through a reporting condition in NERL's licence.
We also fully endorse the use by CAA of delivery incentive mechanisms which mean that NERL bonuses on 3Di in the years 2017-2019 will be dependent on the successful implementation of harmonised TA at 18,000 ft. We view this as a very positive innovation for incentivising delivery of critical projects, and a welcome response to airline feedback on delivery incentivisation in the RP1 and RP2 consultations.

3Di Measure -UK and Irish positions articulated.

The adoption of the 3Di measure for RP1 was a welcome innovation by NERL which recognised the desire of the airline community for improvements to fuel efficiency by measuring both horizontal and vertical trajectory components. With the learning and data from the first 4 years of operation in place, and evidence of the continued commitment and improving maturity of the measure within NERL, the Airline community is highly supportive of the both retention and incentivisation of the 3Di measure for RP2.

We consider this metric better drives actual airline fuel saving performance than a simple horizontal measure. Whilst NERL has produced figures that appear to show an increasing "enabled fuel saving" we believe that more work needs to be done on this metric in a collaborative way with the airlines to ensure that airlines are able to fully realise the potential of the measure. It will also be very important that clear statements on anticipated fuel savings and a means of evaluating achievement against promised savings, will be a vital aspect of any business cases for development that are considered in RP2.

Whilst the airlines recognise the evolution of 3Di, as we have previously stated, the airlines are concerned that this measure seems to be set with a wider dead band than we would anticipate, given the measure has been in place for one control period already.
We understand the argument by CAA that a narrower band could result in perverse incentives if the measure does not work as anticipated. Given the importance of this measure to the community as a whole, and our concern about the transparency of the level of actual fuel savings, we remain however uneasy about the actual level of incentive properties that such a wide dead band will promote. We therefore ask the CAA to review the banding, and assess any opportunity to tighten the incentive and ensure transparency of actual savings.

At a FAB level, whilst overall, we are encouraged that the importance of the 3di metric is recognised by NERL, and by the CAA in the RP2 plan, we are also highly disappointed that no such component exists in the IAA plan for RP2.

We understand the argument from the IAA that such a 3Di measure is not required, as the airspace already operates with free horizontal route airspace. The community however still request the adoption of such a measure for Irish airspace in order to provide benchmark data. The collection of this data would allow an improved understanding of how efficient the airspace is, and to allow comparisons and negotiation with other ANSP's.

FAB En Route Capacity

The airline community is encouraged that the CAA appears to have understood the desire of the airlines to maintain strong incentives for NATS to maintain and in some areas improve the performance which is so critical to our customers. The continued use of incentives for NATS, above and beyond those set at EU level, is welcomed.

C1 – We maintain our stated position that a FAB combined target of 0.28 mins delay/flight against an EU wide target of 0.50 is broadly at a suitable level, as there would currently be marginal benefit and significant cost in driving any further significant reductions beyond this point. On this basis we believe that pending the review of the C1 measure, by the PRB, that this target is endorsed by the airline community.

C2 – There is broad agreement from the Airline community on the C2 target at the FAB level for RP2 and we perceive the linkage of bonus and penalty to the target to be a sensible approach.

C3 –The Airline community agrees that the C3 target is appropriate for RP2. As CAA has identified, this is an important measure for airlines as it does place additional weighting on long delays and delays early in the day that can be highly disruptive to an airline's day long operation.
We are therefore also very supportive of the initiative under the RP2 performance plan that only allows bonus to be paid on this measure if the C1 FAB target is also met.

C4 – The Airline community is supportive of the retention of the rare daily excess delay measure from RP1, which provides incentive to avoid individual days of severe disruption.
We note that in the current RP2 plan that it only presently applies to NATS in the UK. Given the undisputed negative operational and financial impact of such delays to all airlines across the FAB, we see no convincing reason why the same measure should not apply equally to the IAA. In order to provide a consistent FAB approach to such events, we therefore propose that this C4 measure be extended to cover the entire UK & Ireland FAB.

Bonus and Penalties

The airline community is broadly content with the maximum incentive pot attached to each measure as detailed in slide 36, however, where incentivisation of an additional measure is proposed by the airlines, we would anticipate this to be incorporated by reducing the others proportionally to their current values. Given the importance of TANS performance to airline performance and passenger experience, the airlines propose that TANS Arrivals ATFM targets become incentivised, alongside incentivisation of an additional measure of TANS Departures.

We understand the variations in dead bands between various measures reflect the CAA assessment of the level of maturity of each of the incentive measures.
For clarity, we believe that incentive schemes should be asymmetrical for all KPIs and apply the basic principle that a bonus is respectively more challenging to attain than a penalty.

We have given significant consideration to the issue of how best, within the constraints of the RP2 structure, the CAA can deal with the high financial and reputational impact of delay to airlines, including liabilities under EU 261 for delays entirely caused by ATFM. Given the limitations of the scheme, we believe that it is appropriate for this potential for financial impact to be reflected by CAA in the relative proportions of available incentivisation attached to penalties and bonus.
Specifically the allocation of the amounts should recognise that NATS are actually receiving payment for delivering the required performance in the form of the charges paid, and that failure to deliver this “paid for” service results in substantial airline costs, far in excess of the charges paid.

Our conclusion is therefore that CAA should re-examine the current allocation of bonus and penalty at risk, and re-weight to give a greater proportion of the total towards penalties than is current proposed.

Terminal Air Navigation Capacity ATFM

Despite the broad agreement of the community on the en-route capacity targets, we are concerned and disappointed at both the level and breadth of targets which the CAA has currently proposed on Terminal Air Navigation, and the lack of meaningful incentive on the TANS provider/s to meet them.

Following CAA clarification that ATFM delay targets in the terminal environment included all delay causes, the airline community has strong views on Chapter 8 of the RP2 Plan. The average level of delay in the terminal environment is of a far greater magnitude and therefore passenger and operational impact, than the NATS attributable delay detailed under the C1-4 metrics.

We have considered the CAA view that weaker targets on TANS may be the correct solution, in order to allow or encourage entry of competitors to the market. It is the community position that we view the likelihood of any significant market entry to TANS provision to be extremely low over the coming 5 year period regardless of targets. In addition, if there were a choice between actual improvement of performance through tightened measures, or facilitating a theoretical possibility of entry to the TANS market which may or may not derive competition derived improvements, the community would at this stage have a strong preference to bake in the TANS performance improvements that are to be facilitated by the various airspace improvements during RP2.

From a regulatory perspective, we are also quite concerned on the likely negative impacts of this weak target, and we perceive there are likely to be unintended and perverse consequences. TANS at most UK airports including LHR and LGW, are operated by NSL, which is part of NATS, as is NERL. We believe that as a rational business, by setting a weak

target on NSL TANS with no incentive or penalty and a tight target on NERL, with penalties and bonuses it is entirely logical that NATS whether consciously or subconsciously, will seek to shift the reported cause of delay into the most "beneficial" place from a business perspective. In this case, by creating a weaker TANS target with a greater delay allowance and no penalty for failure, NATS will be incentivised to shift delay into terminal assigned causes in order to protect the tighter En-route ATFM target and the financial incentives on it. Not only does this create opportunities to avoid providing the service that is being paid for, but it fails to address the overall delay that passengers experience.
One potential solution to address this would be to place these targets on NERL and not NSL. This may seem counter intuitive, however NERL has by the greatest impact upon level of delay at the airports as they are responsible for the airspace surrounding the airport through which all traffic has to route both inbound and outbound.

The airline community therefore believes there are 4 areas that are required to be addressed:

1. The targets detailed are not challenging enough particularly at the 2 largest airports, Heathrow and Gatwick. The logic of using a historical average high (e.g. 2.66 at LHR which is higher even than the performance for the past 2 years), is not understood and is deemed too high an initial benchmark to be of relevance.

2. The targets set are flat across RP2 and do not recognise any of the various programmes which will realise benefit during RP2. For example, NATS itself has publicised TBS through a number of media outlets in recent weeks and the system should be fully functional by mid-2015. This tool will enable traffic to be more accurately spaced at LHR and LGW thus enabling more efficient operations. However, its primary benefit will be the reduction in the significant proportion of ATFM delay at LHR that is caused by strong winds on the approach.

   NATS itself has stated that TBS will reduce inbound ATFM delay due to strong winds by 50%. Given that ATFM delay due to strong winds accounts for approximately 70% of the delay into LHR, this reduction will be of significant benefit at LHR.

   Furthermore independent parallel approaches will further assist in reducing the levels of delay inbound to LHR. The major redesign of the airspace in SE England through the LAMP project can only further reduce ATFM delay as a modern airspace structure will allow more efficient routings. This will in turn result in greater resilience to weather events such as thunderstorms. Even ATFM delay due to fog will be reduced as airports will benefit from improved ILS; it is forecast that the replacement ILS at LHR, for example, will result in reduced spacing by successive aircraft during LVPs.

Consequently, having analysed the promised potential benefits of each of these improvements, it is proposed by the community that the LHR average ATFM delay per flights should be as follows:

Fig1. RP2 Proposed Arrivals ATFM per Flight LHR

	2015	**2016**	**2017**	**2018**	**2019**
Target (min)	2.20	1.50	1.40	1.30	0.50

In detailing these figures at LHR, it should be noted that the airport is subject to an annual cap of 480K movements, therefore there cannot be an increase in the volume of traffic as the airport currently operates to this level of movements anyway. In addition, the increasing volume of A380 movements will place increased pressure on the airspace, however, it is believed that the airspace improvements detailed still justify year-on-year improvement as their benefit outweighs the impact of the larger volume of A380s.

Fig2. RP2 Proposed Arrivals ATFM per Flight LGW

	2015	**2016**	**2017**	**2018**	**2019**
Target (min)	0.5	0.4	0.4	0.3	0.2

These ATFM target figures for LGW are calculated on the basis of TBS coming online in 2015, with a period of adjustment to become familiar with the process and derive full benefit. This is then followed by further improvements in 2018/19 when LAMP comes on line.

3. Currently there are no bonus or penalty metrics attached to these targets. The level of delay inbound to an airport is driven through lost efficiencies within NERL airspace whether it be weather, staffing or technical. Traffic on approach is handed over to the Tower controller after the spacing has been set and therefore performance of the Tower has minimal impact on the level of inbound delay. The CAA counter argument against attaching bonus/penalty metrics to the target therefore appears to be a flawed.

4. The airline community is surprised to note that the CAA has not yet included a target for TANS departure delay, which is of equal importance to the community as inbound ATFM delay. With the introduction of the A-CDM *(Airport-Collaborative Decision Making)* tool there is now the capability to attach metrics to start delay through simple assessment of the time between TOBT *(Tactical off blocks times)* and TSAT *(Target Start-up Approval Time)*.

   LHR now has a mature A-CDM system whereas the LGW system is due to be introduced during 2014. Currently, start delay averages 1.5 minutes per flight at LHR. A combination of more efficient use of the arrival runway, which should result in less

TEAM traffic onto the departure runway, and airspace change at LHR through delivery of Phase 2 of the LAMP project, gives opportunity for year-on-year improvement. Therefore, recognising that the majority of the benefit will be afforded by LAMP Phase 2, the community proposes that a LHR start delay target should be introduced and set at:

Fig3. RP2 Proposed Metric on Departure Start up delay per Flight LHR

	2015	**2016**	**2017**	**2018**	**2019**
Target (min)	1.4	1.2	1.0	0.8	0.2

(Start-up delay excluding regulated flights, calculated using average difference between TOBT and TSAT excluding flights without a CTOT)

Given the scale of process and airspace improvements that are due to be introduced during RP2, the community judges that the targets we have proposed are realistic and achievable. We also believe that by embedding such targets within the plan, NERL and TANS providers will produce further incentives to ensure that any joint work to deliver these critical benefits is managed closely and that they are delivered on time to the earliest possible benefit of the passenger. This incentivisation to deliver is especially critical at LHR, where NATS benefits for Heathrow are back-end loaded to the RP and are at greater risk to slip further.

The community anticipates that NATS will argue that the performance levels proposed by the airlines are not achievable. When considering these airline proposed targets, we would like the CAA to note that the levels of targets that were proposed by BA and other airlines for RP1. In the event, the airline analysis of the NATS targets and those proposed by the airlines, proved to be significantly closer to the actual levels of performance than both the levels proposed by NATS and the CAA's final targets. We reiterate that our aim is not to ask for unrealistic and unachievable performance, but that we use our analysis of real data and in depth day to day understanding of delay causes to arrive at realistic goals to deliver passenger benefit.

LGW Departures ATFM

Given that LGW A-CDM has yet to enter service, the airline community does not propose to attach targets to LGW at this juncture. It is suggested that the average start delay 2015-16 is reduced by a factor of 3 by the end of the RP2 period.

UK Cost Efficiency

The airlines have recognised the steps taken by NATS/NERL during RP1, to improve operational efficiency within their business and the improvements that this has generated. As laid out in our previous RP2 Airline Special interests paper, we remain concerned at some areas of the business where we perceived further efficiencies could and should be made, and we made suggestions of several such areas where we encouraged the CAA to take action.

We have been greatly encouraged therefore, to see the much more rigorous and holistic approach taken by the CAA in determining the Cost Efficiency allowances for RP2, and the action taken in many of our suggested areas. The CAA and its consultants appear to have done a thorough job of examining and challenging NATS's operating costs and we therefore broadly support the CAA's proposals in most areas.

1. MET cost Base

We need comfort and transparency that the MET cost base only includes costs rightly attributable to UK aviation, i.e. that services provided to other European countries for volcanic ash work is fully allocated to such countries, or at least not passed to UK aviation.

2. Opex Contingency

We strongly support the CAA decision not to allow the proposed NERL opex contingency. As the airline community have stated since the consultation for RP1 until this time, this type of allowance is not present in a competitive and efficient business, and we recognise the steps that CAA have now taken to address this issue for RP2.

3. Pay and Package Costs

Share Scheme Costs We support the action of the CAA in disallowing the £3mpa employee share scheme costs proposed by NATS having identified that these are not admin costs. We view this as a most helpful precedent that demonstrates the ability of NATS to continue to offer additional benefits to their employees, but to do so they must fund it from their own P & L.

Salary opex While we welcome the CAA proposal to cap NATS's opex allowance for salaries at an CPI increase, the airlines are concerned that this only addresses the future cost base, rather than addressing the concerns raised by IDS in relation to the benchmarking of current salaries (and benefits in general). Given that the IDS report also placed current salaries at above market rates, the airlines do not agree that even a CPI increase is appropriate until salaries fall in line with market rates.

We believe that there is an inherent issue with the current structure of the labour market for ATCO's that is creating an artificially high salary and package baseline which could and should be addressed by changing the training and employment process to be closer in line to that experienced in the wider economy.

There is no EU labour market for ATCOs, not least because artificial barriers to the free movement of labour have been erected by ANSPs (including NATS), which do not recognise each other's ATCO qualifications. Sector-specific training creates a number of restricted local/national labour markets, each controlled by a single employer, enjoying a monopoly on recruitment and training. NATS recruits only to a level to meet its immediate/planned needs, so there is no competitive tension in the UK ATCO labour market. As a result, individuals do not incur entry costs and are guaranteed employment at prevalent salary levels, and enjoy a salary even during training.

In the absence of any competitive influence, ATCO remuneration is set at a level which reflects the aspirations of ATCOs and the willingness of NATS to meet these. There is no incentive on NATS to drive efficiency, because it is remunerated by airlines for ATCO costs. The UK market for en-route services is demonstrably uncompetitive, which is why it is subject to economic regulation. In addition, when ATCOs leave NATS (through retirement or otherwise), there is no efficient labour market from which NATS can seek replacements. This means that attrition tends to increase, rather than reduce salaries.

The ATCO labour markets are heavily influenced by unions, which – unlike other essential services, enjoy a right to strike. This has led directly to anti-competitive outcomes at national and EU-level, for example significant downgrading of EU plans for the Single European Sky (SES II), which would have led to greater efficiency in the provision of en-route services.

This contrasts starkly with the EU labour market for pilots, which is driven by supply and demand - and is consequently highly competitive. Individuals become pilots only after significant personal investment in training, which must be completed before entering the labour market, is expensive and takes a long time to complete. When pilots do enter the labour market, there is no guarantee of salary and/or employment. Remuneration for pilots is set at a level which reflects their individual investment and risks – and as such, the market is self-regulating. If remuneration were to become too attractive, more pilots would join the market and salaries would fall in response to an over-supply of labour. In this way, remuneration is maintained at the market clearing rate. In addition, because the air-transport sector is highly competitive, airlines which over-remunerate pilots are prone to lose market share – and in so doing, will lay off pilots, who will either seek employment with more efficient airlines, or exit the market.

The airlines would like CAA to consider the inherent possibilities of total remuneration level change which would be opened up by addressing this labour market issue. Historically this may have been seen as too difficult to solve and without precedent in the ATC industry. As raised by the community during the CAA Panel Session, however, there is now a clear precedent for change in this area, which has been set by the changes to ATCO training in Ireland, where training is now carried out by a separate commercial company, and is paid for by the trainee before any promise of employment. This provides a helpful benchmark for change within the UK & Ireland FAB itself.

The airlines clearly recognise that such wholesale change cannot be introduced for the start of RP2; however, it is entirely feasible for CAA to lay out a path-way within the RP2 plan to facilitate the necessary steps and suitable mechanisms to ensure that effective competition is introduced into the ATCO labour market, to achieve the following means:

- liberalisation of training – NATS (and by default the airspace users) should not finance ATCO training and third parties should be allowed to train ATCOs to standards set by NATS (and other ANSPs);
- NATS (and other ANSPs) should be required to recruit ATCOs on an objective basis; and
- Where this results in an over-supply of applicants, NATS should adjust ATCO salaries to market-clearing levels.

4. Pensions

In 2009, NATS closed its defined benefit (DB) pension scheme to new entrants; however, it continued to operate the DB scheme for existing members, at the same high contribution rates. It is only recently that NATS have taken any action to alter any indexation rates to members in the DB scheme, significantly later than airlines and wider industry have followed this course of action. Despite this action, the scheme continues to enjoy contribution rates well above benchmark market levels.

The airlines also note that the contribution levels enjoyed by members of the replacement DC scheme also appear to be weighted heavily towards the very highest end of the pensions market.

The result of this approach, which is atypical of what has happened in the wider economy, is that unless further and more material reductions to scheme benefits are made, the excessive costs of the NATS DB scheme will endure over the long term; indeed, until the last member enrolled before the scheme closure to new members has retired. As discussed (and agreed) at the bilateral meeting of 21st March 2014, it is extraordinary that NATS (a supplier) is able to provide both a DB and a DC scheme to its staff at levels, that airlines (its customers) cannot.

The CAA has stated that is appears from their investigations, that the NATS DB scheme is protected by legal statute and/or agreement. As has been raised previously however, despite explicit requests by the community to NATS, the details have not been provided to airlines. The transparent sharing of such information would have been helpful in allowing the airlines to start from a level position of understanding of the issues, and facilitate a more constructive direction of possible action at a much earlier stage.

However, regardless of disclosure of the information, or any statutory protections, it is not one of the CAA's duties to protect this. On the contrary, the CAA's duties include a requirement to ensure that NATS incurs operational costs efficiently. Moreover, DB schemes are inherently more risky than defined contribution (DC) schemes, because potential shortfalls between available funds and liabilities may be manifest; indeed, NATS DB scheme currently has a significant shortfall. It would be wholly wrong for airlines to be forced to underwrite either the direct costs or risks associated with NATS' DB scheme.

It is therefore incumbent on the CAA to reach a regulatory settlement which not only allows for reasonable (therefore not DB) pension contributions, but does not allow any risk resulting from pre-existing or ongoing DB commitments to find its way into NATS' regulated WACC. It is noteworthy that the CAA shares NATS' DB pension scheme and so, if anything, it is even more important that the CAA is seen to take a position on pensions that reflects what has happened in the wider economy.

We welcome the conclusions from the CAA study on pension costs, and the initial developments in the CAA RP2 plan that recognised that the historical full pass through of pensions should not continue. We support it as highly appropriate that airspace users should receive back the full value of any surplus to the scheme and we strongly agree with the concept that the airspace users should not bear the full cash contribution allowance.

However, we do not believe that the steps taken by the CAA go nearly far enough to address the overall burden of the scheme still borne by the users – its customers.

To be clear, the CAA's duty is to replicate the pension costs of a competitive entity. Given the extraordinarily high level of NATS contributions, we therefore do not agree that the CAA's current proposals to limit pass through to 80% go far enough to address the overly generous and burdensome NATS pension scheme which the CAA's consultants have agreed does not contribute at a market competitive level.
It has already been evaluated by the CAA and their consultants that an appropriate cap on the contribution rate for a competitive pension scheme is c.20% of pensionable pay as was determined in the LHR process. We see no compelling reason why the same assessment should not apply for this review, and that the airspace users should pay any higher contribution than this 20% cap.

We also insist this pass-through allowance should take no account of any scheme deficit as this deficit was accrued by NATS delaying action where a rational and commercial entity responsible for its own costs would have taken faster action. We are adamant that the community expect no less action to be followed as a part of the CAA's deliberations on the RP2 process.

Given the wide ranging action on pensions taken across all industries and sectors, we repeat our earlier review that the duty of the CAA is to ensure efficient operational expenditure. Whilst a 20% cap on contributions offers a suitable interim measure, long term we expect CAA to take further action to enable NATS to make further structural changes to the scheme. Whilst it may be impractical to expect CAA to successfully take apart any statutory protection of the NERL DB scheme for RP2 itself, we fully expect that CAA use the time available in the RP2 period to take the relevant steps to effect the necessary legislative changes required to allow further action to be taken on pensions to take effect for the start of RP3.

Irish Cost Efficiency

Given the progress made by the UK CAA, the airlines are disappointed by the apparent lack of challenge from the IAA NSA to the IAA ANSP's proposals. Sufficient evidence is needed to give confidence that that the IAA NSA has discharged its regulatory obligations fully.

1. IAA WACC

A clear example of the apparent lack of challenge is the seemingly straight acceptance by the IAA NSA of the proposals from the IAA ANSP's consultant on WACC. This is in clear contrast to the CAA, where a consultant was appointed to review the NATS's consultant's proposals and this investigation concluded with a dispute to the NAT's proposal on WACC. The airlines do not accept that the WACC for the IAA ANSP should be set at the current level which would reflect a more risky business than that of NATS or Heathrow and Gatwick who are all privatised companies.

2. IAA Pay

The Performance Plan states that for the IAA ANSP 'a minor reduction in staff numbers is expected over the RP2 period'. This seems to be incongruous when looked at in the context of staff costs are increasing by ~3% p.a. This seems to indicate either a fundamental change in grade mix, or more likely, that average salaries will be increasing at about double CPI (i.e. about 3.2% p.a.). If this level of increase were the case, it is clearly significantly above that being experienced in the rest of the UK or Irish economies. Such incremental and market uncompetitive opex above CPI should clearly be disallowed.

3. IAA Pensions

We are concerned that the lack of separation between the IAA ANSP and IAA NSA could have contributed to the late closure of the DB pension scheme, which must be costing airspace users a considerable amount. Such incremental opex should be disallowed

The airlines are also concerned that allowing a hybrid DB/DC to continue to be offered to new starters is excessively and unnecessarily generous, and would not be found in a competitive market. Following the example set by the UK airports, and the steps already made by CAA for NATS, such incremental opex should be disallowed.

Governance

The desire for strong and improved governance has been a key theme of the airline community's response to the NERL RP2 consultation. The presentation of the RP2 Performance Plan on the 14th March, emphasised to the Airline community the continued need to push for a robust governance structure in RP2 that also transcends the FAB between the NATS and the IAA.

The disparity between NERL and the IAA ANSP in the consultation process and opportunities for airline involvement for the RP2 period was notable, as was the apparent lack of commonality between the UK and I element of the FAB plan.

We wish to work collaboratively with NATS and IAA and CAA in developing a RP2 Governance structure that enables all parties to work together to deliver a successful RP2 for the UK and Ireland individually and for the joint FAB. We acknowledge that key elements are already in place but feel that governance can be developed further to ensure all aspects of the RP2 Performance Plan are successfully governed and delivered. We draw many similarities with our work with the UK Airports under Q6 where both sides have enjoyed benefits from closer collaboration, and we believe that much of the structure we have proposed in this arena is relevant and transferable to RP2.

This type of approach is designed to enhance collaboration, reduce risk and ensure a more balanced outcome in terms of priorities, strategic planning and choices regarding investment options.
The Airport Commission has recognised the importance of an "optimisation strategy" to improve the operational efficiency of UK airports and airspace and the importance of a senior delivery group to drive forward several implementation programmes which are of national importance. The type of governance approach we have highlighted below is key to achieving this level of optimisation for all users of UK & I airspace, and the airlines are ready to engage constructively in this process by contributing their resources expertise and assets in the relevant fora.

We set out some key principles below for consideration in this respect.

- A streamlined structure that efficiently delivers the services and investments required by the airline industry.

- Governance structures which enhance the capacity of the Airline community to actively engage in it and influences the priorities and expected outcomes.

- Governance which gives airlines a timely opportunity to be actively involved in decision making processes at critical stages of the portfolio development process.

- Recognition that an improved passenger experience is based on the efficient delivery of the two building blocks of Service Quality and Infrastructure.

- The opportunity for the governance structures in RP2 to build on those in place in RP1, and taking forward the best practices from other sectors such as the airport environment.

- Minimal layers of governance are most likely to ensure that issues are resolved and that agreed developments are progressed without delay.

- A simple structure, which targets the most appropriate people for the content, is most sustainable and drives most benefit over the long-term for all parties.

WACC

General Comments
In general we support the CAA's conclusions that the appropriate WACC for NERL has fallen between RP1 and RP2. We also note that the CAA has determined rightly, in our view that the cost of debt and the equity beta have fallen.

However, whilst we recognise that the CAA has correctly concluded on the direction of travel for the WACC, we do not believe that they have arrived at the correct destination. It is our view that the CAA's proposal for a WACC of 5.75%, significantly overstates the true cost of financing for NERL, and that it is particularly overstated when taken against the recently determined WACC figures for both LHR and LGW.

The airlines contend that NATS' WACC clearly must reflect a significantly lower risk business than is indicated by the currently proposed marginal difference in WACC to that of airport say, LHR. This lower risk is generated by the "Portfolio effect" of inherent risk spreading enjoyed by NATS, by having traffic and therefore revenue, generated by airports across the UK and worldwide. This is in clear contrast to a single airport, i.e. LGW or LHR, where were there to be a shock at that airport, NATS' business would not be entirely impacted, whereas the traffic and revenue at that airport would be. In addition NATS enjoys significantly less risk than either LGW or LHR, due to the risk sharing mechanism that is in place to protect from sudden and severe capacity shocks. We believe that a more realistic target for WACC would be closer to 5.00%.

Equity Beta
We support the CAA's decision that the equity beta for NERL has fallen between RP1 and RP2. We also support the CAA's decision to reject NERL's assertion that their equity beta is 1.35. To assume that NERL is 35% more risky than the average business, and more risky than the airlines it serves, is simply untenable.

To be clear, the first round effects of any demand volatility and/or shock is borne by the airlines, not NERL or the airports. As the CAA is aware, the airlines have an incentive to fill their aircraft and so the standard response is for airlines to seek demand by reducing their yields. In times of demand volatility, it is an entirely rational response for airlines to sacrifice yield for load factor; indeed, most modern yield management systems are based on this approach. It is this reaction that effectively insulates NERL and the airports from any demand risk and ensures that they only bear second order (if any) risk. Therefore, NATS' equity beta is demonstrably lower than that of airlines as the CAA rightly notes.

In its determination of the equity beta, the CAA makes reference to the equity beta for the regulated airports, noting that the correct beta for NERL would be lower than this number.

It was the view of the airline community at Heathrow, that the CAA had significantly overstated the appropriate equity beta for HAL. It was the opinion of the airlines that HAL's equity beta was less than one. Indeed the independent expert assessment commissioned by Virgin Atlantic and BA from the respected expert Prof Sudi Sudarsanam was that the evidence 'does not contradict BA's view that HAL's equity beta is likely to be less than 1…'

Consequently, as the CAA has effectively used the airport equity beta as the upper range for its choice for NERL, and that this number is artificially high, it must follow that:

1. the CAA's selection of the equity beta for NERL based on the 50th percentile is too high given the excessive upper range; and
2. that the CAA has not, as it has suggested, chosen the actual 50th percentile

Total Market Returns

The CAA has selected a TMR of 6.25% arguing that this figure is consistent both with the CC's determination for Northern Ireland Electricity and its decisions on Heathrow and Gatwick. This however, is not strictly accurate. As the CAA itself notes, the CC 'assumed a TMR of approximately 6%' Given that this is the case, the airline community would like the CAA to explain its rationale more fully as to why it believes that the appropriate TMR is not 6% but 6.25%

Gearing

In the view of the community, the correct gearing level is that which delivers the lowest WACC; with the risk being borne by those best able to bear it. We consider that the level of 60% used by CAA in its calculation of WACC is rather too conservative. As seen during the recent downturn NERL has had few, if any, issues based on its current gearing and risk position. It would appear that a gearing level above 60% could easily deliver the required resilience. If the systematic risk remains unchanged then levels up to a cap of 75% would appear to be acceptable.

Cost of Debt

From the information provided, the construction of the benchmark indices used by PWC in coming to its recommendation for the CAA is unclear. In order to arrive at the correct conclusion, NERL must clearly be benchmarked using indices of institutions with broadly comparable risk factors. The airlines are extremely concerned about the potential usage of the BoAML index or similar, being used by PWC used for the calculation of NERL's cost of debt. Whilst historically financial institutions may have been an appropriate inclusion within comparator indices, given the higher risk and debt levels associated with financial institutions since the banking crisis, the use of any index which includes financial institutions is now likely to overstate the cost of debt for a notionally efficient and low risk company like NERL. This overstatement of debt is highly likely to have lead the CAA to falsely and erroneously set a cost of debt that is too high.

We request that CAA clarify whether the indices used by PWC included Financial institutions, and if so, that the cost of debt be reviewed against an alternate index that does not include financial institutions.

Choice of Appropriate Tax Rate

We support the CAA's recognition that the appropriate tax rate has fallen. However, we would like to see the CAAs calculations that support the effective tax rate that they have chosen.

Appendix 1

List of Airlines and Associations consulted on this document

British Airways
IAG

AerLingus
Virgin Atlantic Airways
Ryanair
EasyJet
Monarch
TUI
KLM
American Airlines
United Airlines
Jet2
Thomas Cook
Flybe
AEA
BAR-UK
BATA
IATA
LACC (LHR)