

# Proposal to modify the NATS (En Route) plc licence in respect of governance and ring- fencing: Notice under section 11(2) of the Transport Act 2000

**CAP 1368**



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# Executive summary

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## Overview

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1. As the UK's monopoly en route air traffic services provider, NATS (En Route) plc (NERL) is critical to the provision of a safe, efficient and sustainable air traffic service. NERL is subject to economic regulation by the CAA through a licence issued under the Transport Act 2000 (the Act).
2. The NERL licence includes conditions that are designed to ensure that the assets, cash flows and other financial resources of NERL are used solely for the benefit of its regulated monopoly business. These rules are designed to protect stakeholders (including passengers, whose fares ultimately fund the business) by making it less likely that NERL will suffer financial distress or failure. In that context, it has become clear in recent years that consumers are less willing to tolerate poor service or service disruptions, and so it is appropriate to consider whether the current ring-fencing arrangements are fit for purpose to manage the risks that could emerge from NERL getting into financial difficulties.
3. Currently, NERL is something of an anomaly in the UK regulation landscape. The CAA, as economic regulator of NERL, does not currently have significant regulatory oversight of corporate governance. Given the risks identified by the Ad-Hoc Review of NATS-related risks in 2012/3, the CAA felt it was appropriate to review the governance arrangements presently in place for NERL.
4. This review identified a number of issues with the governance and ring-fencing of NERL. These issues were outlined in our publication 'Initial proposals on modifications to NATS (En Route) plc licence in respect of Governance and Ring-fencing' ([CAP 1287](#)), published in April 2015.
5. Following a period of consultation, we have now developed a set of final proposals as to how we intend to modify NERL's licence. We consider that these modifications will significantly strengthen NERL's governance and

ring-fencing arrangements, and thus provide a higher level of protection for passengers through protecting NERL's financial and non-financial assets for the benefit of users and providing the CAA with more information about the financial strength of NERL.

6. On governance, we propose to mandate that NERL appoint all the non-executive directors of NATS to the NERL board. In addition, we propose to require NERL to appoint two Mandatory Independent Directors to the NERL board unless the CAA consents otherwise. We also propose to require that Directors of NERL will have regard exclusively to the interests of NERL, where potential conflicts exist between the interests of the NERL and those of any other group company
7. On the financial ring-fence, we propose to:
  - refocus the annual directors' resources certificate to give additional clarity and emphasis on operational and financial resources;
  - require new statements from the directors setting out the processes used and factors considered in issuing the certificates;
  - require new annual certificates from NERL's directors that the licensee has complied with specific elements of the ring-fence;
  - require certificates of compliance with the ring-fence conditions to be issued each time the licensee declares or recommends a dividend;
  - require the maintenance of an intervention plan to assist a special administrator in the event of insolvency.

## Chapter 1

# Introduction

## Purpose of this document

- 1.1 This document sets out and explains the CAA's formal proposal to modify the air traffic services licence of NERL in relation to governance and ring-fencing with the object of ensuring that users are adequately protected from risks which arise outside of the regulated business.
- 1.2 The CAA published its initial proposals on this issue in April 2015. After consultation and careful consideration of stakeholders responses, the CAA is now publishing its formal proposals which:
- modify condition 1 – Interpretation and construction to require that compliance certificates are approved either at a board meeting at which all the directors of NERL present, or that the Certificates are issued under a written resolution signed by all NERL's directors;
  - modify condition 5 – Availability of Resources and Financial Ring-Fencing to:
    - re-focus the annual directors' resources certificate to separate NERL's certification that it has sufficient operational resources from its certificate of sufficient financial resources;
    - include new statements from the directors setting out the processes used and factors considered in issuing the certificates;
    - require new annual certificates from NERL's directors that the licensee has complied with specific elements of the ring-fence;
    - require certificates of compliance with the ring-fence conditions to be issued each time the licensee declares or recommends a dividend;
  - introduce a new licence Condition 7 requiring NERL to maintain an intervention plan to assist a special administrator in the event of insolvency;
  - introduce a new licence Condition 8 which will ensure the independence of the NERL board's decisions and contain a requirement that at least two 'Mandated Independent Directors' (MIDs) must sit on the NERL board unless the CAA consents otherwise;
  - modify Condition 9: Prohibition of cross-subsidies to clarify and simplify the prohibition against cross subsidies and ensure it aligns clearly with the parallel requirements of European law.

- 1.3 The CAA received four responses to its initial proposals, from NATS, NATS trade unions (NTUS), easyJet and Heathrow Airport Limited (HAL). These responses have been published [on the CAA's website](#). We have carefully considered the responses and consequently have made a number of changes to our proposals. The changes are explained together with our formal proposals in chapters 2 and 3.

## Terms used in this document

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- 1.4 This document and the preceding consultation are about the relationship between the various businesses that constitute the NATS group. For the purposes of this document, references to NATS relate to NATS Holdings Limited, which is the ultimate parent company of the NATS group of companies. For example, we have referred to NATS as the stakeholder that responded to the initial consultation, on behalf of NERL. References to NERL or the regulated or monopoly business relate to NATS (En Route) plc, which holds a licence for provision of en route services under the Transport Act 2000 (the Act). For example, we have referred to NERL exclusively when talking about the activities of the company. References to NSL relate to NATS (Services) Limited, which is a subsidiary of NATS that provides terminal air navigation services (TANS) at airports, as well as other commercial services in the UK and overseas.

## Views invited

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- 1.5 Under section 11(1) of the Act, the CAA may modify the conditions of a licence if its holder consents to the modifications.
- 1.6 Under section 11(2) of the Act, before making modifications to the licence, the CAA must publish a notice setting out the proposed modifications, their effect and the reasons for the proposal, and must state the period (of not less than 28 days) within which representations may be made regarding the proposed modifications. NERL has indicated that it will consent to the conditions appended to this consultation, which also serves as the statutory notice under section 11 of the Act. Accordingly, this document constitutes such a notice and the CAA welcomes comments on the proposed modifications. Any comments should be sent, if possible by e-mail, to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) by no later than 9 March 2016. Alternatively, comments may be sent by post to:

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- 1.7 The CAA would expect to make responses available on its website for other interested parties to read as soon as practicable after the period for written comments has expired. Any material that is regarded as confidential should be clearly marked as such. Please note that the CAA has powers and duties with respect to information under section 102 of the Act and the Freedom of Information Act 2000.
- 1.8 If you would like to discuss any aspect of this document, please contact Stephen Gifford ([stephen.gifford@caa.co.uk](mailto:stephen.gifford@caa.co.uk)) or Robert Toal ([robert.toal@caa.co.uk](mailto:robert.toal@caa.co.uk)).

## Next steps

- 1.9 The CAA is allowing 28 days for comments on this document. Subject to the scale and nature of the responses received, the CAA would expect to publish its final decision in March 2016.
- 1.10 In relation to the proposed licence Condition 8 to require the appointment of MID's to NERL's board, on the basis of the engagement that we have had with NERL since the publication of our initial proposals in April 2015, we would expect NERL to apply for the CAA's consent to exempt it from complying with this Condition. We expect this application will be received alongside NERL's response to this consultation.
- 1.11 Thus, we anticipate granting and publishing our consent alongside a decision document as a result of this consultation in March 2016.
- 1.12 This would allow the modified conditions to take effect by 1 April 2016.

## Structure of this document

- 1.13 The remainder of this document sets out:
- the revised proposals to strengthen governance arrangements of NERL (Chapter 2);
  - the revised proposals to strengthen the NERL financial ring-fence (Chapter 3);
  - an overall summary of the CAA's formal proposals (Chapter 4).

- 1.14 Appendix A contains the proposed text of the modified and new conditions with the amendments against the existing text of the relevant conditions (where applicable) marked.

## Chapter 2

# Governance

## CAA's initial proposals

### Issues identified

- 2.1 In setting out its initial proposals on governance, the CAA noted that the current licence did not include specific standards for board leadership and governance for NERL. Instead, the CAA had chosen to focus on ensuring that there was appropriate ring fencing of the regulated company to protect it (and therefore users) from risks arising elsewhere in the NATS group.
- 2.2 However, the CAA considered that there were good grounds for reassessing these arrangements not least as best practice in corporate governance, and the regulatory oversight of it, had evolved over recent years. In many regulated industries, corporate governance standards had been tightened. In some cases these changes had been made as a direct response to financial failures.
- 2.3 The CAA's [Ad-Hoc Review of NATS Related Risks during 2012/13](#) and subsequent analysis had revealed that there were weaknesses with the corporate governance of NERL including:
- the board of the regulated company did not contain any non-executive members;
  - board meetings of NERL were “nested” within the board meetings of the NATS group;
  - the existing structure of the NATS group did not ensure sufficient focus on the activities of NERL by its board.
- 2.4 More generally, the CAA considered that the structure of the Public Private Partnership (PPP) could lead to confusion over the governance of NERL for a number of reasons including:
- NERL was not obliged to comply with the Combined Code on Corporate Governance (as opposed to NATS Holdings which was required by the PPP to comply with the Code);
  - the non-executive Partnership Directors (PDs) of NATS Holdings appointed by the DfT to represent the financial interests of the government did not have any role in ensuring regulatory compliance by NERL;

- the non-executive members of the NATS Holdings board, although they represented the shareholders, were subject to the same potential conflicts of interests as the executives;
- the incentive and bonus structures of managers and board directors of NERL may cause them to have regard to the impact of their activities and decisions on the wider NATS group of companies, rather than focussing solely on the regulated business.

2.5 Overall, the CAA considered that these weaknesses with the corporate governance of NERL could lead to users' interest being harmed in the event of certain scenarios, such as if NERL experienced financial stress. Though the probability of such events occurring may not be high, they would be likely to have a high impact.

## CAA's proposal

2.6 After considering and assessing a number of options to improve the oversight of NERL's governance arrangements, the CAA took the view that its concerns could be best addressed by NERL's board containing independent members. In this way, the CAA could be more confident that the management of NERL would be sufficiently focused on that business rather than on the broader interests of the NATS group. The CAA considered that the presence of independent directors would be expected to have a number of benefits including that:

- independent directors would be better placed to challenge any management decisions that prejudiced the interests, or conflicted with the obligations of NERL, particularly at times of difficulty;
- independent directors would be well placed to weigh up the issues dispassionately if there were conflicts of interest between the interests of NERL and the interests of NATS or other companies within the group;
- independent directors should enhance the overall oversight and culture of regulatory compliance, including the efficiency of the ring-fence regime, by bringing "fresh eyes" and independent oversight, especially in relation to the compliance certificates NERL produces for the CAA;
- even if the likelihood of NERL suffering financial stress may not be high, high quality independent directors would bring benefits to the business through their board work irrespective of whether NERL was subject to an event of financial distress;
- although they would not be able to block a corporate decision, provided that NERL was required to inform the CAA of an independent director's resignation and the reasons for it, even a

minority of independent directors would provide an extra warning signal that there were issues that needed to be investigated;

- the presence of independent directors could be expected to drive better corporate governance standards generally.

2.7 In summary, the CAA took the view that there was a strong case for NERL to appoint a minimum of two competent independent directors to the NERL board, to set quorum rules so as to include these directors in decisions, and to reiterate in the licence that the directors of NERL should focus on the interests of NERL alone.

## Responses to the initial proposals

### NATS

2.8 In its response on governance, NATS suggested that if the CAA were to impose the requirements set out in the initial proposals, then it would have failed to act in accordance with its specific statutory duties or those imposed by public law more generally.

2.9 In particular, NATS considered that the CAA's powers were restricted to introducing changes to conditions that were necessary and expedient and the CAA's proposals would not meet these tests. Specifically, NATS considered that the proposals did not comply with these requirements in a number of ways:

- they failed to have regard to the protections and benefits already afforded by the PPP arrangements;
- they did not convincingly identify the need for such significant change while the PPP arrangements remained in place;
- the CAA had not properly turned its mind to the question of the minimum requirements that would address the concerns that it had identified.

2.10 NATS further argued that the additional requirements, with their associated costs would be inconsistent with the CAA's duty to promote efficiency and economy on the part of licence holders.

2.11 NATS indicated that it could be helpful to include explicit recognition in the licence that NERL directors (when acting in that capacity) owe their duties to NERL.

2.12 In NATS' view, the existing PDs were as expressly independent as the MIDs proposed by the CAA as well as holding significantly greater powers. NATS further observed that: