

Section 16 advice to the Secretary of State for Transport on extending the length of the notice provisions for termination in the Air Traffic Services licence

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Executive summary

Background

1. This report sets out the CAA's statutory advice to the Secretary of State for Transport on issues relating to a request by NATS to extend the length of the notice provisions for termination in the NATS (En Route) plc ("NERL") licence. The CAA's advice was given in October 2015.

Forward look

2. The Secretary of State asked the CAA to consider how the industry may be affected by future changes. We concluded that:
 - There is considerable scope for technological and regulatory change particularly at the European level;
 - The obligations on States and ANSPs may evolve in a number of alternative directions which are not easy to anticipate in advance; and
 - The Government may therefore need to be mindful that it does not unwittingly constrain or make more costly actions that it may need to take in the future.

Comparison with other regulated industries

3. We compared NERL's licence with those of other regulated industries and concluded that:
 - There is an evidence based justification for NERL's licence to be shorter than for those industries with much longer investment cycles;
 - NERL is not disadvantaged by its licence terms compared to other ANSPs in Europe;

- Reintroducing exclusivity for NERL is likely to have no practical effect but would give the wrong signals generally by appearing to add an artificial barrier to competition; and
- There may be some benefit in removing the current text in the ‘terms of the licence’ as it relates to a period which has now ended.

Impact of a licence extension

4. Europe Economics were commissioned to consider the financing issues relating to licence duration. They considered the impact the minimum period before which a licence can be terminated has upon the volumes and costs of debt-raising by regulated companies and found the following:
- Regulated companies do raise significant volumes (30 per cent and sometimes more) of debt that matures after the minimum termination notice period. The minimum termination notice period does not act as a hard ‘cap’ on the ability of firms to raise debts;
 - When the minimum termination notice period is longer, firms tend to raise debt with a longer maturity profile — each additional month of extension in the minimum termination notice period means average debt maturity profiles of almost one month greater;
 - Debt that is raised beyond the minimum termination notice period is materially more expensive — the cost of debt maturing beyond the minimum termination notice period is around half a percentage point greater than of debt maturing inside (other things being equal); and
 - When asset lives are longer, this tends to offset the impact of bonds maturing beyond the minimum termination notice period. If assets have a life of more than six years greater than the minimum termination notice period, that entirely offsets the yield elevation of maturation lying beyond the period.

5. We concluded that:

- Despite the difference in yields, the financing benefits to NERL of a 25 year notice period are likely to be relatively modest compared to the overall level of determined costs;
- The effects on the incentives on operating costs are difficult to quantify but given operating expenditure is six times the cost represented by the return on capital, the Government should be mindful of the effects on these incentives from extending the licence;
- There may be a good case to extend the notice period to 15 years to reflect the average asset lifecycle and regulatory depreciation period (although there does not seem to be a good reason why the earliest date for termination should currently be extended beyond the current time in 2031); and
- There does not seem to be a strong case for extending the notice period beyond 15 years.

Broader impacts

6. We considered how extending the notice period of the licence might affect the Government's ability to adapt change particularly in the context of the Single European Sky. We concluded that:

- Extending the licence notice period may be seen to be adding an additional impediment to at least some paths to a more integrated Single European Sky;
- Should the Government be obliged to change the current licensing arrangements in a shorter timeframe, extending the notice period would be likely to increase the cost of doing so; and
- It could be expected that it would be less costly to compensate in respect of a 15 year notice period than a 25 year notice period.

Chapter 1

Introduction

- 1.1 This report sets out our advice to the Secretary of State for Transport on issues relating to a request by NATS to extend the length of the notice provisions for termination in the NATS (En Route) plc (“NERL”) licence. The CAA’s advice was given in October 2015.

Reason for conducting the study

- 1.2 In September 2011, following an application from NATS, the Department for Transport consulted on a Government proposal to amend terms 6 and 7 of the licence under which NERL, the regulated business of NATS, operates to:
- i. increase the notice period after which the licence can be terminated from 10 to 25 years; and
 - ii. remove the restriction which specifies that notice may not be served until the 20th anniversary of the grant of the licence.
- 1.3 Taken together, these changes would have had the effect of ensuring that the Secretary of State could not, under terms 6 and 7 of the licence, terminate the licence for at least 25 years following the decision to terminate and serving of notice.¹
- 1.4 The Department for Transport consulted on these issues in September 2011, but did not take action on the duration of the licence at that time.
- 1.5 In November 2014 NATS requested that the Department give a fresh review to this issue.

¹ This would not impact the current powers held by the Secretary of State to terminate the licence in the particular circumstances specified in Schedule 3 of the licence e.g. with the agreement of the licensee, where the licensee was insolvent or had breached key licence duties.

- 1.6 On 22 June 2015 the Department for Transport formally asked the CAA under section 16(1) of the Civil Aviation Act 1982 to provide further evidence and analysis to support a decision on potential changes to the duration and/or structure of the NERL licence. The Terms of Reference for this request are attached at Appendix A.
- 1.7 In order to ensure a robust analysis of the financial issues involved, the CAA commissioned additional input from consultants Europe Economics.
- 1.8 This report is the CAA's advice. The report of the consultants is being published separately.

Legal framework for the analysis

- 1.9 This report is intended to assist the functions of the Secretary of State under Part I of the Transport Act 2000 ("the Act") in his capacity as the licence authority under section 7(7). In performing his licensing functions the Secretary of State is subject to a number of statutory duties which can be summarised as:
- A primary duty to maintain a high standard of safety;
 - Secondary duties to act in a manner best calculated:
 - to further the interests of aircraft operators, aerodromes, and end consumers where appropriate by promoting competition in the provision of air traffic services;
 - to promote efficiency and economy by licence holders;
 - to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences; and
 - to impose on licence holders the minimum restrictions which are consistent with the exercise of those functions.
- 1.10 This report has been prepared with these duties in mind and the CAA has also had regard to the UK's obligations under European legislation.

Structure of this document

1.11 The remainder of this report follows the structure set out in the Terms of Reference as follows:

- Background: A summary of the current air traffic services framework and how it may change in the future;
- Cross sector comparison: A brief comparison of the NERL licence and those of other regulated utility providers;
- Impact of licence extension: An outline of the likely impacts of the potential changes to the NERL licence including an assessment of the strength of the arguments put forward by NATS for (a) extending the minimum period of notice to terminate the licence and (b) reintroducing licence exclusivity in favour of NERL; and
- An assessment of any potential broader impacts.

Chapter 2

Background

2.1 This section considers the UK and European contexts for the provision of air traffic services and the relationship between the two. It then sets out the current allocation of risk between NERL and its direct users.

UK domestic context

2.2 NATS is the UK's leading provider of air traffic services. It handles about 2.2 million flights and 220 million passengers in UK airspace. Following the Act, NATS was transferred in 2001 to a public private partnership (PPP) in which the Government had, and continues to have, a 49% stake. The remaining shares are owned by a strategic partner, The Airline Group, with a small shareholding held by LHR Airports Limited² and NATS employees. The Act requires the providers of air traffic services in the UK to hold either a licence or to be exempted from licensing. NERL is the only UK licence holder, all other air traffic service (ATS) providers currently being covered by a general exemption which runs until 2019. In preparation for the licensing regime the operations of NATS were divided into two subsidiaries:

- The en route component and closely associated services which were considered to be effectively a monopoly to be subject to a licence issued by the Secretary of State were allocated to NERL; and
- The component which provided terminal air traffic services at airports was allocated to NATS Services Limited (NSL) with the services being provided under the general exemption rather than under an economic licence, as these services were considered contestable.

2.3 This report is directed solely at the NERL licensed business.

² The owners of Heathrow airport.

- 2.4 The provisions of the NERL licence are made up of terms and conditions. Under the Act, conditions can be modified by the CAA subject either to the agreement of NERL³ or following a reference to the Competition and Markets Authority.⁴ Where provisions are expressed as terms, the Act does not expressly provide for their modification. Licence terms are a matter for the Secretary of State and not the CAA.
- 2.5 The principal terms are attached at Appendix B. The key terms for the purpose of this report are terms 6 and 7. Term 6 states:
In so far as it authorises the provision of air traffic services in respect of the En route (UK) Area, unless revoked in accordance with the terms of Schedule 3, this Licence shall continue to have effect until determined by not less than ten years' notice in writing given by the Secretary of State to the Licensee following consultation with the CAA, such notice not to be served earlier than the twentieth anniversary of the grant of this Licence.
- 2.6 Term 7 refers to the En Route (Oceanic) service⁵ in the same terms.

European context

- 2.7 Following the adoption of the first Single European Sky (SES) package in 2004, The European Union (EU) gained competence in air traffic management and air navigation services⁶ and began legislative and regulatory activity in this domain. In 2009, a second SES package was adopted that comprises of five main pillars (performance, safety, technology, airport capacity and the human factor) and updated the existing high-level legislative framework:

³ Section 11.

⁴ Section 12.

⁵ The En Route (Oceanic) service relates to services provided in a portion of North Atlantic airspace in collaboration with the Irish Aviation Authority (IAA) under an International Civil Aviation Organisation (ICAO) mandate. This a relatively small part of the licensed business not covered by the Single European Skies regulations.

⁶ "Air Navigation Services" have a wider definition than "Air Traffic Services". For example they include meteorological services and aeronautical information services.

- the Framework Regulation⁷ establishes the European Commission as the regulator for the civil sector and the Single Sky Committee to assist it in its regulatory activities. It also provides the basis for a performance scheme (including targets) for air navigation service providers;
- the Service Provision Regulation⁸ establishes a common certification system and charging principles for civil ANS providers;
- the Airspace Regulation⁹ which requires States to organise airspace into functional airspace blocks (FABs) to contribute to overall performance of the system. (This has subsequently been moved to the Service Provision regulation as part of the second package of Single European Sky (SESII) legislation; and
- the Interoperability Regulation¹⁰ which establishes basic requirements to ensure that Air Traffic Management (ATM) and Air Navigation and Surveillance (ATM) systems, equipment and procedures operate seamlessly.

2.8 The SES regime thus covers a number of dimensions, some technical, (requiring common standards etc) and some providing a framework of economic regulation (effectively controlling charges and setting standards for safety and service quality through a combination of a performance regulation and charges regulation for fixed five year periods).

2.9 States are required to collectively organise areas of airspace into Functional Airspace Blocks¹¹ (FABs) with the objective of reducing fragmentation and achieving improved performance. The SES

⁷ Regulation No 549/2004:
<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32004R0549>.

⁸ Regulation No 550/2004:
<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32004R0551>.

⁹ Regulation No 551/2004:
<http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=uriserv:l24034>.

¹⁰ Regulation No 552/2004:
<http://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX:32004R0552>.

¹¹ These are the currently groupings of the airspace of more than one State e.g. the UK and Ireland have formed a FAB.

Performance Scheme¹² is based around plans at a FAB level setting out targets for safety, capacity (delay), environment (flight efficiency) and cost efficiency for a fixed reference period. The current period known as RP2 (Reference Period 2) started in 2015 and lasts to 2019. Certain targets, such as en route cost efficiency, are set at a charging zone level – in effect State level.

- 2.10 These plans are drawn up by national supervisory authorities (CAA for the UK), adopted by the Member States in the FAB and are required to be approved by the European Commission.
- 2.11 Increasingly, responsibility for safety standards has been shifting to the European Aviation Safety Agency (EASA), while the role of the Network Manager has been conferred on Eurocontrol to provide greater co-ordination to pan-EU airspace management.
- 2.12 Two SES implementing regulations have a particularly direct bearing on economic regulation:
- the Performance Regulation which requires performance plans setting out performance targets for safety, capacity, environment (flight efficiency) and cost efficiency over a five year period; and
 - the Charging Regulation which sets out the principles underlying the cost base for air navigation service charges.
- 2.13 Together these closely resemble a five year price control. The CAA has adapted its approach to the regulation of NERL to align with these requirements.
- 2.14 The joint UK-Ireland FAB Performance Plan for the five years of the second SES reference period (RP2) was submitted to the European Commission in June 2014 with a further addendum in October 2014. The Plan proposed a set of performance targets for safety, capacity (delay), the environment (flight efficiency) and cost efficiency. The Commission

¹² Regulation No 390/2013 (the “Performance Regulation”):
<http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1477297198647&uri=CELEX:32013R0390>.

has since assessed these targets as consistent with relevant EU-wide targets.¹³

The relationship between UK and EU regulation

- 2.15 The economic regulation of UK air traffic services has to achieve the twin aims of meeting statutory duties under the Act and fulfilling the UK's obligations under the Single European Sky (SES) Regulations. If conflict arises between the formal legal requirements, the CAA would expect EU legislation to take precedence.¹⁴
- 2.16 The UK regulatory arrangements pre-date SES but have been adapted to be consistent with EU requirements.

¹³ Commission Decision 2015/348 of 2 March 2015:
<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015D0348&from=EN>

¹⁴ Not all of NERL's business is subject to the SES regime (e.g. the Oceanic service is not subject to SES legislation; and access to infrastructure for Military use is governed under a separate contract).

Chapter 3

A forward look

- 3.1 This section looks forward to anticipate possible changes in technology and regulation where these may have implications for the licensing regime. It considers such changes:
- for the medium term, there is a snapshot from the RP2 Performance Plan (although there may be scope for the investment programme to evolve to reflect new information); and
 - for a longer perspective over 25 to 30 years where there is a wider range of possible future scenarios.

The medium term

- 3.2 The UK-Ireland FAB Performance Plan included a clear forecast of traffic, revenues, operating costs and quantum of capital expenditure in RP2.
- 3.3 In terms of technology, a large part of change is being driven by the technological pillar of SES. The Single European Sky ATM Research (SESAR) programme has developed a number of technological advances which are moving into a deployment phase, based on a European ATM Master-plan. This Master Plan is expected to provide a roadmap for the implementation of technologies in a synchronised fashion to optimise its net benefits. (The longer term aspects of this Master Plan are discussed from paragraph 3.18 below.) In the medium term this will largely bring EU wide services up to an aligned baseline.
- 3.4 In the medium term the investment programme involves:
- a new Flight data processing system; and
 - new common workstations able to support new controller tools and ultimately 4 dimensional flight-trajectory.

- 3.5 In addition, as part of the FAB plan for RP2, NERL planned to implement major technological and airspace planning changes particularly in South-East airspace which were forecast to have very large fuel efficiency benefits to be realised by the end of RP2 (or more likely the beginning of RP3).
- 3.6 In all likelihood there will be a variation in the composition of the programme – NERL are currently discussing with users the possibility of bringing forward some of the new technology and being able to reduce the sustainment spending on legacy systems. Past experience suggests that there may also be variances in the overall spend as the five-year review period proceeds. The current regulatory approach provides a fair amount of protection to the company as the full cost of capital spending including financing is passed through to users. In practice this has tended to be to the benefit of users rather than NERL as the tendency in previous review periods has been to under, rather than over, spend the expected capital expenditure for a review period.
- 3.7 Despite the implementation of the early stages of the SESAR programme the anticipated capital expenditure programme for RP2 appears to be comfortably sustainable. As Table 1 illustrates, the regulatory asset base (RAB) of the UK air traffic services portion of NERL is expected to go down over the course of RP2. The reduction occurs because the investment in each year is less than the regulatory depreciation. For reasons discussed below in paragraph 3.13 this difference arises largely because the regulatory depreciation is high over this period rather than because the capital expenditure is particularly low.

Table 1: Projection of the Regulated Asset Base

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
Closing RAB*	1,142	1,077	1,012	964.0	911.0	860.1
Total actual net capital expenditure	128.1	140.7	134.6	113.8	108.8	100.3
Allowed depreciation	-185.2	-195.9	-198.0	-193.1	-180.7	-179.8
Capex minus depreciation	-57.1	-55.2	-63.4	-79.3	-71.9	-79.5

Looking forward to RP3

- 3.8 There are some risks to NERL of a legal and political nature because Europe is looking for consistency while the UK approach has been more “bespoke”, dealing with the unique set of circumstances arising from NERL’s private sector status and the legacy of previous regulation. There is also a step change in cash flow expected in 2021 as a result of the approach taken to depreciating the assets which were transferred as a result of the Public Private Partnership.
- 3.9 While there has been considerable effort to adapt the UK regulatory regime to be consistent with SES, there are some differences from the way it is applied in other Member States. These have largely arisen as a result of the legacy of regulation of NERL for ten years or so before SES came into effect and the fact that NATS is financed on a fully commercial basis. The UK has therefore tended, where appropriate, to use the remaining flexibility in the regulations to avoid outcomes which are unnecessarily inconsistent with NERL’s financing and the legacy incentive regimes to promote cost efficiency and other user interests.
- 3.10 In this context, it should be noted that the statutory duties under the Transport Act 2000 for both the Secretary of State and the CAA include:

- to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences.¹⁵

3.11 There is no equivalent provision in SES regulations. It should be noted that the degree of separation of NATS from government and its need to operate subject fully to private sector financial disciplines are unique in the EU. This form of requirement has, therefore, not been relevant generally to other States and ANSPs, but can be very significant for NATS. (It was critical, for example prior to SES, in the period following the events of 9/11 when falling traffic put NERL's finances under strain and required a re-opening of the price cap).

- The depreciation and cost of capital elements of charges are based on a RAB which is indexed by inflation each year rather than on the nominal valuations in the statutory accounts under International Accounting Standards. This RAB approach allows a consistent approach before and after the implementation of the SES Performance Scheme, avoiding double or under-recovery and is consistent with the approach generally adopted for UK utility regulation. Elsewhere in the EU an approach more closely linked to International Accounting Standards is generally applied;
- The CAA applies an approach to depreciation based upon this RAB based approach. This further diverges from the statutory accounts in that:
 - The value of the assets (in real terms) transferred to the Public Private Partnership in 2001 is all being depreciated on a straight line basis over 20 years from the date of that transfer;
 - New investment has been depreciated over the average economic life (15 years) of all assets from the point of spend. The more generally applied approach in Europe is to depreciate from the point of each asset coming into beneficial use and to be based on the life of individual assets; and

¹⁵ Section 1(2)(c) for the Secretary of State and section 2(2)(c) for the CAA.

- The CAA has applied an approach to pensions based on cash contributions (subject to UK pension legislation and practice) rather than an accounting approach based on International Accounting Standards. Although this does not change the ultimate pension liabilities as they fall due, it does tend to be more prudent and eliminates the need for accrual for differences between cash and accounting costs.

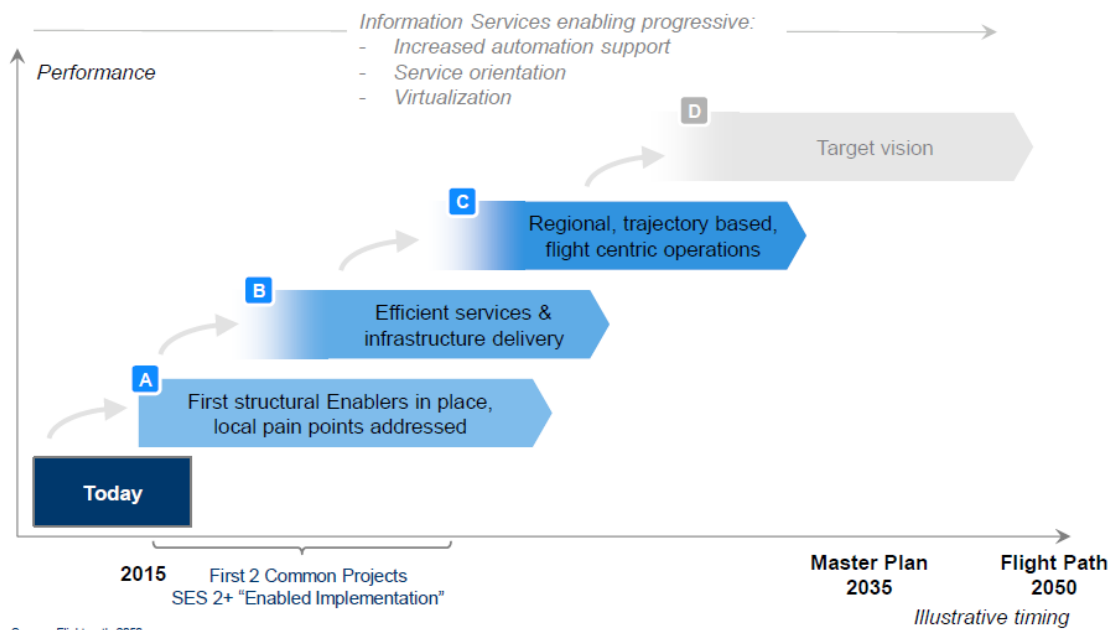
- 3.12 The UK has been explicit in these differences in its component of the UK-Ireland FAB Performance Plan. We consider that they fall within the current provisions of the EU regulations. However, it seems highly likely that, in future, the degree of latitude to apply the regulations in this way may be reduced – either by the EC taking a narrower interpretation of best practice in emerging guidance under the existing regulations, or by further amendment of the Regulations.
- 3.13 As alluded to above, the value of the RAB at the time of the Public Private Partnership transaction in 2001 is being depreciated on a straight line basis over 20 years. As a consequence there will be a significant reduction in annual depreciation 20 years later (i.e. from 2021). Absent any change to the profile of depreciation, this could clearly represent a significant downward step in the internally generated cash-flow for dividends and investment from that point onward.
- 3.14 This approach has been neutral in terms of the value of the business. However, it has had the effect of deferring the return of value to shareholders from the early years of the PPP to the latter part of this 20 year period. In recent years NERL has been paying relatively large dividends based on this revenue (rather than paying down debt which would have taken gearing down below efficient levels). NERL should be anticipating this change in five years' time and managing shareholder expectations. It may also place greater emphasis on raising additional debt (or equity) finance in line with any subsequent net increases in the RAB.

Longer term

- 3.15 Change tends to be implemented relatively slowly in air navigation services. This largely reflects the fact that it is a safety critical activity based on the co-ordination of international standards in the air and on the ground. Nevertheless, the technology and methods of operation of the industry are expected to change very significantly over the next 25 to 30 years – and to a large extent a vision and Master Plan already exist at a European level to allow this to proceed in a coordinated way.¹⁶
- 3.16 It is less clear how the organisation and governance structure of European airspace will change. Will the European project converge on a true “Single European Sky” with a single en route service provider, or a reduced number of providers operating at FAB level? Or will at least some of the intrinsic economies of scope and scale be achieved within a less centralised framework of separate service providers but with a greater degree of network coordination and technological collaboration? In either case, will there be a move towards service providers developing more efficient ways of working by commercial agreements, industrial partnerships, mergers and acquisitions or will it continue to be driven by State agreements or even collectively at the EU level? A large part of any consideration of NERL’s licence duration will depend on the extent to which the Government wants to either retain flexibility to discharge its future international obligations and how much it is prepared to constrain its future options (or to risk making them more complex and expensive to achieve).
- 3.17 The ATM Master Plan is based on European air navigation services moving in phases from the current situation of relatively limited co-ordination, inefficient routings based on fixed route structures and a high level of human intervention to a system where information is shared between service providers, conflicts are resolved as part of the planning

¹⁶ Six major Air traffic management “functionalities” are now mandated in the SESAR “Common Project Regulation” for the coming decade, with further common projects likely to emerge in the next few years.

process and aircraft can fly the optimum four dimensional flight path with minimal tactical intervention. Illustrative timing is envisaged as follows:



3.18 For users this is expected to lead to benefits in terms of safety, capacity, flight efficiency and cost efficiency but it will involve considerable additional equipment on aircraft. (The ATM Master Plan estimates that the capital costs to users are at least as great as the capital costs to ANSPs and airports). There are risks to the programme, not least because the benefits are heavily dependent on a high take up by users and for some users there will be no net benefits or the greatest net benefits would favour those users that make the investment at the last possible moment.

3.19 The ATM Master Plan identifies the cost to EU ANSPs and the Network Manager of deploying SESAR for the baseline and the first step (up to c2024) of up to €6.5 billion (2012 prices). This of itself does not appear to be a sum which would cause a massive uplift in NERL's RP3 capex plans because:

- NERL would only represent a small percentage (perhaps say 10%) of the overall cost;
- A large part of the core supporting systems are already expected to be commissioned as part of the RP2 programme; and