

Initial proposals on modifications to NATS (En Route) plc licence in respect of Governance and Ring-fencing

CAP 1287



Published by the Civil Aviation Authority, April 2015

You can copy and use this text but credit the CAA.

Enquiries regarding the content of this publication should be addressed to:

Markets and Consumers Group, CAA, 4th Floor, CAA House, 45-59 Kingsway, London WC2B 6TE.

The latest version of this document is available in electronic format at www.caa.co.uk

Contents

Executive Summary	4
Chapter 1 Introduction	9
Chapter 2 Background	13
Chapter 3 Purpose and objectives of the Governance and the financial ring-fence proposals	20
Chapter 4 Development and assessment of initial proposals on Governance	24
Chapter 5 Development and assessment of initial proposals on the financial ring-fence	37
Chapter 6 Areas we do not propose to change	50
Chapter 7 Cost of implementing the initial proposals	55
Chapter 8 Summary and Next Steps	57
 Appendices	
Appendix A Illustrative proposed modification to Licence Condition 5: Availability of Resources and Financial Ring-Fencing	
Appendix B Illustrative proposed additional Licence Condition 7: Requirement to Maintain an Intervention Plan	
Appendix C Illustrative proposed additional Licence Condition 8: Requirement for mandated independent directors and corporate governance	
Appendix D Illustrative modification of Licence Condition 9: Prohibition of cross-subsidies	

Executive Summary

Overview

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. NERL's licence contains conditions – the "ring-fence" 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 the ultimate consumers whose fares ultimately fund the business) by making it less likely that NERL will suffer financial distress or failure.
3. Since NERL's licence was amended in 2007 to remove a requirement to comply with to the Code of Corporate Governance, the CAA has not sought to set standards for Board leadership and governance for NERL. Instead, the CAA has chosen to focus on ensuring that there is appropriate ring fencing of the regulated company to protect it from risks arising elsewhere in the NATS group.
4. However, since these obligations were introduced, the world of corporate governance, and the regulatory oversight of it, has changed. In many regulated industries, including those in which there were already rules dealing with corporate governance, standards have either been introduced or tightened, sometimes in the wake of significant failures. Past issues from which these changes have evolved include the financial difficulties and break up of Hyder, and the failures of Railtrack and Enron, as well as more recent and high profile financial failures and bail outs.
5. Given that the existing ring-fence has been in operation through a period when the UK and world economies have experienced the most significant financial crisis since the 1930s, and NATS has not itself encountered significant financial difficulty arising from that crisis, it could be argued that the conditions work well. However, it is important that the ring-fence conditions are seen to be robust over a reasonable period into the future and to be agnostic as to the ownership structure of NERL/NATS so that they are fit for purpose irrespective of who owns it.

6. It is also fair to say that perceptions and awareness of risk have changed in recent years, with consumers being less willing to tolerate poor service or service disruptions. Clear examples of the reaction to these disruptions can be seen in the media response to incidents such as recent failures in air traffic control and railway engineering overruns. At the same time, we consider that public acceptance of perceived failure of the regulatory regime to protect consumers is also lower.
7. In response, many economic regulators have already enhanced the regulatory oversight of corporate governance in recent years. New rules have been introduced without substantially affecting the ability of the owners of the business to be represented on the board of the regulated company or to exercise their ownership rights. In some cases, the requirements are very extensive, including for independent directors to outnumber executives, the chair of the regulated company to be independent and for board members to have particular expertise or be approved by the regulator.
8. Within that context, starting with the Ad-Hoc Review of NATS-related risks in 2012/3, we have undertaken a thorough review of the existing governance and ring-fencing arrangements for NERL and have identified areas in which we consider that changes to the licence would provide greater protection for users of air transport services.

Issues identified

9. Our work has found that there are weaknesses with the corporate governance of NERL that may lead to stakeholders' (including consumers') interests being harmed. In particular, the board of NERL does not contain any independent members (unlike the NATS Holdings board) and board meetings of NERL are "nested" within the board meetings of the NATS group. Each of these elements of NERL's board governance makes it more likely that, especially at times of financial or other difficulty, the members of the board of NERL are at risk of becoming exposed to conflicts as a result of duties they hold as members of the boards of other companies within the NATS group.
10. In addition, we have provisionally found that the existing financial ring-fence may not, in its current form, be sufficiently robust. In particular:
 - the reporting and certification of resources obligations in the licence do not provide the CAA with sufficient transparency over the ongoing stability of the business, including whether it is operating effectively in accordance with its obligations;

- while NERL provides an annual certificate that it has sufficient resources to continue operation for the next two years, it does not have to explain how it reached this conclusion or detail the factors it has taken into account in providing the certificate;
 - NERL currently has no obligation to certify compliance with specific licence obligations prior to declaring a dividend or other distribution of capital. Such a requirement is a feature of a number of licences observed in other regulated sectors;
 - Some of the obligations in the licence (for example in relation to cross subsidies) are insufficiently clear either for NERL to comply with them easily, or the CAA to oversee and enforce them; and
 - NERL does not have any plans in place to provide appropriate assistance to a special administrator in the event of its insolvency.
11. The CAA considers that the current arrangements are significantly less robust than those prevailing in other regulated sectors and are, in many respects, an 'outlier' of regulatory practice.

Initial proposals

12. The CAA's overall aim is to ensure that NERL's financial ring-fence and corporate governance arrangements, taken as a package, make sure that it maintains sufficient financial and non-financial resources to conduct its regulated activities and that it avoids exposing stakeholders and consumers to unacceptable risks arising from either its financial structure, or from NATS' activities outside the regulated business. These latter risks could arise, for example, through its relationship with its unregulated subsidiary NATS Services Ltd (NSL). In addition, the CAA wishes to receive direct assurance that the appropriate policies and procedures are in place to achieve this outcome.
13. In practice, this is likely to require the regulatory regime to deliver the following outcomes:
- appropriate mitigation of any risks and conflicts of interest faced by the boards of NERL and NATS Holdings, the parent company of the group;
 - a management of NERL that is sufficiently focussed on that business rather than the broader interests of the NATS group so that risks are not traded off between NSL and NERL;

- that the apparent culture of regulatory compliance within NERL can be easily observed by the CAA and maintained in the future;
 - protection for the funds provided (indirectly) by consumers through NERL's regulated revenues for the benefit of the regulated business;
 - sufficient transparency for the CAA as to the ongoing financial and operational robustness of NERL; and
 - clarity and lack of ambiguity in NERL's licence obligations, so that the licence can apply with as little as possible need for consents or comfort letters.
14. The CAA considers that delivery of these outcomes will mitigate the likelihood of a range of high impact events which, although the probability of them occurring may not be high, could cause disruption to NERL and, in doing so, harm the interests of consumers. In order to deliver these outcomes, the CAA has identified a range of potential changes to the governance and ring-fence arrangements of NERL that it considers will address these problems and bring regulation of air traffic services more into line with best practice observed elsewhere.
15. On governance, the key proposal is to mandate NERL to appoint at least two non-executive and independent directors with appropriate skills to promote greater rigour in its corporate governance and enhance NERL's compliance culture, and ensure that two of them are required to be present for the board to be quorate. We also propose that the licence make clear that where potential conflicts exist between the interests of NERL and those of any other part of the NATS group, the directors of NERL must act independently and ensure that they have regard exclusively to the interests of NERL.
16. On the financial ring-fence, we have identified a package of proposals:
- re-focussing NERL's annual directors' resources certificates to give additional clarity to, and emphasis on, operational as well as financial resources;
 - new statements from the directors setting out the processes used and factors considered in issuing the resources certificates;
 - new certificates from NERL's directors that the licensee has complied with certain ring-fence elements, such as not to enter into cross defaults nor give or receive cross-subsidies;

- a new requirement to re-state the compliance certificates prior to the declaration of dividends; and
 - maintenance of an intervention plan to assist a special administrator in the event of insolvency.
17. Overall, the CAA considers that the proposed changes set out in this consultation are incremental and build on the protections that already exist. We consider that, when taken as a package, these changes will ensure that the ring-fence is as robust as possible without imposing unnecessary burdens on NERL, or completely eliminating the possibility of financial failure, which, of itself, encourages discipline on the part of the company's management.

Next steps

18. We welcome views from stakeholders on all of the issues considered in this consultation document and particularly the CAA's assessment of options set out in Chapters 4 and 5. Having considered responses, we currently expect to issue statutory licence modification proposals during August 2015 with a view to modifying the licence formally in October 2015 such that the proposed changes will take effect from 2016.
19. Under Section 11(1) of the Act, the CAA may modify the conditions of a licence if its holder consents to the modifications. Should NERL choose to withhold its consent to any of the changes the CAA decides to make following this consultation, the CAA will have the option under Section 12(1) of the Act of making a reference to the Competition and Markets Authority to investigate and report upon whether any matters specified in the reference and which relate to the provision of air traffic services by or on behalf of a licence holder operate against the public interest or may be expected to do so.

CHAPTER 1

Introduction

Purpose of this document

- 1.1 This document sets out, for consultation, the CAA's initial proposals on how the air traffic services licence of NATS (En Route) plc ("NERL") should be amended to meet concerns first identified in the CAA's Ad Hoc Review of NATS-related risks in 2012/13. That Review found that the current arrangements for governance and ring-fencing may need to be strengthened to ensure that users are adequately protected from risks which arise outside of the regulated business.
- 1.2 In light of that finding, the CAA has undertaken a thorough review of the existing ring-fence conditions and identified areas in which we consider that changes to the rules in the licence would provide greater protection for consumers.
- 1.3 In particular, this document invites representations on proposals by the CAA to:
 - modify Condition 5: Availability of Resources and Financial Ring-Fencing in the licence held by NERL to:
 - re-focus the annual directors' resources certificate to introduce a new certificate related to operational resources which will be separated from the existing requirement related to financial resources;
 - include new statements from the directors setting out the processes used and factors considered in issuing the certificates;
 - require new certificates from NERL's directors that the licensee has complied with specific elements of the ring-fence; and
 - 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 requiring NERL to maintain an intervention plan to assist a special administrator in the event of insolvency; and

- introduce a new Licence Condition which will ensure the independence of the NERL board's decisions and contain a requirement that at least two 'Mandated Independent Directors' must sit on the NERL board and that these directors should sign the certificates referred to above.
- 1.4 The CAA also welcomes views on initial proposals to simplify the licence in relation to the prohibition on giving or receiving cross subsidies which is explained further in this document.

Terms used in this document

- 1.5 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. 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). The prices NERL can charge users and certain quality standards, such as its capacity/delay performance, are subject to economic regulation by the CAA. 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 other commercial services, in the UK and overseas.
- 1.6 References to consumers and stakeholders are to include (among others) operators and owners of aircraft, operators and managers of aerodromes, passengers and other users of aircraft and persons with rights of property carried in them. References to Air Traffic Administration are to the special administration regime under sections 26 to 33 of the Act.

Views invited

- 1.7 We welcome views on these initial proposals. Any comments on this document should be sent, if possible by e-mail, to economicregulation@caa.co.uk by 12:00 on 8 June 2015. Alternatively, comments may be sent by post to:
- Stephen Gifford
Markets and Consumers Group
Civil Aviation Authority
4th floor
CAA House
45-59 Kingsway
London WC2B 6TE
- 1.8 This consultation document provides interested stakeholders and finance

providers with an opportunity to comment on these initial proposals that represent the CAA's current thinking. We are particularly keen to minimise any risk of unintended consequences. Respondents are encouraged to respond in detail and, where they consider that we should take an alternative approach to that set out in these initial proposals, to provide detailed and fully reasoned responses (and, where relevant, proposals) which fully address the issues set out in the consultation document.

- 1.9 Having considered any responses, we expect to issue our final proposals and a statutory licence modification under Section 11 of the Act during August 2015.
- 1.10 The CAA expects to make submissions available on its website for other interested parties to read as soon as practicable after the period for responding expires. 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.
- 1.11 If you would like to discuss any aspect of this document, please contact Stephen Gifford (stephen.gifford@caa.co.uk) or Robert Toal (robert.toal@caa.co.uk).

Structure of this document

- 1.12 The remainder of this document sets out:
- the background to the CAA's proposals in this area including the relevant statutory framework, the findings of the Ad Hoc Review of NATS related risks carried out during 2012 and the impact of subsequent developments (Chapter 2);
 - the purpose of this review which is to achieve the strategic outcome of ensuring that NERL maintains sufficient financial and non-financial resources to conduct its regulated activities and that it avoids exposing users to unacceptable risks arising from outside the regulated business (Chapter 3);
 - the initial proposals to strengthen governance arrangements of NERL (Chapter 4);
 - the initial proposals to strengthen the NERL financial ring-fence (Chapter 5);
 - a summary of the areas which CAA does not intend to change at the moment (Chapter 6);

- a summary of the costs of the proposed changes (Chapter 7); and
- an overall summary of the CAA's proposals and proposed next steps (Chapter 8).

1.13 The Appendices provide illustrative drafting of the licence modifications that would be required if these initial proposals were implemented in their present form.

Chapter 2

Background

- 2.1 This chapter sets out the context for and background to the CAA's proposals. It puts these proposals in their wider context and describes the statutory framework for the economic regulation of NERL. It goes on to consider how governance and ring-fencing was addressed by the CAA during an Ad Hoc Review of NATS related risks that was carried out in 2012. The chapter concludes by summarising the detailed work programme that the CAA has subsequently carried out to inform these initial proposals.

Context

- 2.2 How a company is governed and led plays an important part in how it performs. A lack of strong Board leadership and governance can lead to problems with financial stability and service delivery. Furthermore, for regulated companies, Board oversight is crucial in creating a culture which ensures compliance with both the letter and spirit of the regulatory rules which are designed to protect consumers generally. For NERL, these rules include the financial ring-fence protecting consumers' funding of the regulated company.
- 2.3 Many regulators in other sectors have reviewed or enhanced the regulatory oversight of corporate governance in recent years. Ofwat, Ofgem, ORR and new regulators, such as the FCA, have taken a strong line in this area. These reviews have seen governance rules develop over time since the significant failures of Railtrack and Enron, and the high profile banking crisis.
- 2.4 As with many other regulated businesses, NERL is responsible for providing a vital public service: it is clearly in the interests of all consumers that this service is provided not only safely, but also with as little interruption as possible to the levels expected (and ultimately paid for) by consumers. While NERL has not experienced the same or similar financial difficulties since the implementation of the Composite Solution to its funding after the events of 9/11, NERL remains liable to:
- situations of financial stress (for example as a result of a prolonged airspace closure);
 - suffering significant outages (most recently in December 2014); and

- increased consumer expectations in relation to the quality and continuity of service that they receive.
- 2.5 Each of these factors has focussed attention more closely on the management of NERL and NATS more generally.
- 2.6 If the financial position of NERL were to deteriorate significantly, harm may arise to consumers. In particular, harm may arise as a result of a diminution or discontinuity in service and/or through greater costs being imposed on consumers (whether as a result of an Air Traffic Administration or otherwise). Specifically, NERL may find that it is unable to continue to invest appropriately in its people, technology and systems to enable it to maintain its monopoly air traffic business and safely and reliably to deliver en route air traffic services. In time, this may threaten the reliability and safety of that service.
- 2.7 The CAA does not take the view that it is appropriate to seek to eliminate the possibility of NERL experiencing financial stress or entering Air Traffic Administration, not least because the possibility of this, and the consequent loss to shareholders acts to discipline the company and its board. In any event, the CAA does not consider that it is possible to eliminate (rather than reduce) this risk in all circumstances: to attempt to do so would be likely to result in unacceptably onerous conditions being put on NERL (for example in relation to guaranteeing the availability of working capital).
- 2.8 However, the CAA does consider that the regulatory regime should reduce the risk of financial distress by constraining the conduct of the company, ensuring its resources are not diverted and that it is not exposed to undue risk. The presence of appropriate ring-fencing and governance rules helps to reassure the CAA that NERL will remain in a position to finance its functions and consumers' interests are not adversely affected.
- 2.9 Furthermore, if financial distress were to occur such that NERL entered Air Traffic Administration, the CAA is of the view that the administrator should have all the resources necessary available to conduct the administration as efficiently and effectively as possible with the minimum disruption to consumers.
- 2.10 We have conducted the review that underpins this consultation in this context, being mindful of the impact that a failure of NERL would have on interested parties more widely.
- 2.11 In this broader context, it appears that the time is now right to revisit the

issue of whether, and to what extent, the CAA should oversee the corporate governance of NERL, as the regulated company delivering the monopoly en route service within NATS.

CAA duties under the Transport Act 2000

2.12 The provision and economic regulation of air traffic services in the UK is governed by the Act. The Act establishes a system of licensing and regulation, including the Air Traffic Administration regime. The licence granted to NERL is designed to satisfy the statutory duties of the Secretary of State and the CAA set out in section 2 of the Act. In summary these are:

- an overriding duty to maintain a high standard of safety in the provision of air traffic services, accompanied by duties:
 - to further the interests of operators and owners of aircraft operators and managers of aerodromes, passengers and other users of aircraft and persons with rights of property carried in them;
 - to promote efficiency and economy on the part of licence holders;
 - to secure that licence holders do not find it unduly difficult to finance their authorised activities;
 - to take account of the UK's international obligations;
 - to take account of any guidance from Government on environmental objectives (no such guidance has been issued to date); and
 - to impose on licence holders the minimum restrictions consistent with the exercise of those functions and not to impose undue burdens on licence holders.

The NERL licence

2.13 The NERL licence includes a number of conditions initially set by the Government in 2001 but which can be modified by the CAA under the provisions of the Act. These include conditions that relate to ring-fencing and governance of certain elements of NERL's business.

2.14 The CAA has the function of enforcing and making modifications to the licence conditions. The procedure for making modifications to licence conditions is found in sections 11 to 14 of the Act which provide that:

- the CAA may modify the conditions of a Licence if the licence holder consents to the modification. The CAA must publish a formal notice of the proposed modifications and consider representations before making a decision; and
- the CAA may make a reference to the CMA at any time requiring it to investigate and report on whether any specified matters relating to the provision of air traffic services operate or might be expected to operate against the public interest. If the CMA does find that such matters operate or might be expected to operate against the public interest, then the licence is modified so as to remedy or prevent the adverse effects identified by the CMA.

2.15 The effect is that modifications can be made either with the agreement of the licensee or, if the licensee does not consent, following a reference to the CMA.

The financial ring-fence

2.16 The regulatory framework to which NERL is subject is designed to promote efficiency while meeting its legal duties, including the duties found in Section 8 of the Act in relation to providing a safe and reliable service. The CAA has, through the regulatory regime, arrangements in place to monitor the financial health of NERL and to respond in the event that that health deteriorates. The ring-fence regime and associated licence conditions are an important part of these arrangements, placing certain constraints on NERL to ensure that the resources consumers provide through the regulated revenues of the monopoly business are available for that business.

2.17 Although we have a duty to ensure that licence holders do not find it unduly difficult to finance their authorised activities, as stated above, the regulatory rules are not designed to remove the threat of bankruptcy, or to remove the responsibilities of the Directors of NERL to manage the business in a responsible manner, given the privilege that NERL has as a monopoly operator. We would, however, expect NERL to inform us at as early a stage as possible of any potential or actual issues. The earlier that we were aware of any such issues, the more able we would be to choose different options for responding to mitigate or contain the situation.

2.18 The directors and shareholders of NERL have the primary responsibility, to decide on the most effective operational, structural and financial arrangements for their business. We do not consider that intrusive intervention by the CAA would be desirable, in the consumer's interest or

consistent with our statutory duties. NERL is tightly integrated with other NATS companies as a consequence of the NATS public-private partnership (PPP) arrangements. Other NATS companies that are not economically regulated owe no duty to the CAA, and we have very limited powers over them. This underlines the importance of NERL's Directors in safeguarding its interests.

2.19 The ring-fence regime, therefore, has the following broad objectives:

- reducing the onset of financial or operational distress by constraining the conduct of the company, ensuring that its resources are not diverted and that it is not exposed to undue risk;
- reassuring the CAA that NERL remains in a position to finance its activities by providing warning signals when symptoms of financial or operational stress appear or threats are identified;
- mitigating the effects of financial or operational stress if it occurs; and
- facilitating the reopening of the price control or the operation of the Air Traffic Administration regime if either becomes relevant.

The CAA's Ad Hoc Review

2.20 During 2012, the CAA carried out a high level review (the Ad Hoc Review) of the strategic outcomes it wished to secure through its regulation of NERL. The review was carried out by a board-level working group in the context of a number of trends, challenges and risks that could potentially frustrate its ability to secure these strategic outcomes including:

- forecasts for long-term traffic and increasing congestion which could challenge traditional approaches to safety management;
- NATS, through its subsidiary NSL, aiming to develop significantly its business outside its en route monopoly;
- NERL taking an increasingly commercial view in its provision of regulated services;
- the ongoing development of the Single European Sky (SES) programme which was expected to challenge NERL's performance outlook, especially in terms of its cost-efficiency; and
- the prospect of changes in ownership of NATS and/or NERL.

- 2.21 The interim findings of the Ad Hoc Review were published in September 2012¹ and a final report was published in January 2013². That report confirmed the strategic outcomes that the CAA wished to achieve as well as the actions it considered would be best designed to help pursue those outcomes.
- 2.22 Broadly speaking, the CAA concluded that many of the risks identified through the Review could be mitigated, but not eliminated, through the CAA taking a different approach to its use of existing regulatory levers. For example, there were a number of areas where more proactive scrutiny by the CAA of NERL's business plans would be desirable. This included the CAA's oversight of NERL's long-term business plans from a safety delivery and assurance perspective and the CAA's oversight of NERL's financial resources.
- 2.23 In relation to governance and ring-fencing, the review did not reach firm conclusions but rather set out the CAA's high-level objectives that would shape a separate review. In particular, the CAA noted that there were various options that it would like to see considered either individually or in combination.
- 2.24 The options identified included both 'preventative' and 'curative' approaches that could be pursued either individually or in combination which would help to strengthen the financial ring-fence. Preventative approaches included options such as requiring NERL pro-actively to confirm compliance with certain conditions before paying dividends, drawing a ring-fence around the whole of the NATS operating companies, and requiring NATS Holdings to underwrite the performance of group service providers on which NERL depends.
- 2.25 Curative approaches related to ensuring that, in the event of financial distress, the CAA could discharge its duties and there would be a smooth and successful process of Air Traffic Administration. The Ad Hoc Review also raised a specific question as to how NERL could demonstrate it had adequate resources when it is required to contract for its staff resource with a NATS business that is not regulated and outside the NERL licence ring-fence.
- 2.26 The CAA noted that it would consider these issues further as part of the future work programme on NERL governance and financial ring-fencing.

¹ <http://www.caa.co.uk/docs/2492/NATSRisksReviewInterimReport.pdf>

² <http://www.caa.co.uk/docs/5/NATSRelatedRisksFinalReport.pdf>

2.27 In light of the findings of the Ad Hoc Review, the CAA established a work programme to consider the application of the governance and ring-fencing arrangements in greater detail. As part of this work programme, the CAA has held a number of meetings with representatives of NATS and requested further information from NATS in order to understand the issues. The substance of this work programme included:

- a detailed assessment of the structure of the Public Private Partnership (PPP) which underpins NATS corporate governance arrangements, including a review of the way the NATS employs staff within its group structure;
- a detailed gap analysis of the existing NERL licence to identify weaknesses; and
- a review of regulatory best practice, which was deemed to be particularly relevant as regulators in the rail, energy, water, health and financial services sectors have all recently considered parallel and comparable risks.

2.28 In the meantime, the December 2013 system failure at Swanwick and the receipt in July 2014 of NATS' comprehensive report on that failure prompted a further wide-ranging CAA review of the NERL licence and regulatory framework. The implications of this work are considered in the next section.

Chapter 3

Purpose and objectives of the Governance and the financial ring-fence proposals

Overall objectives and outcomes

- 3.1 The overall aim of this review is to ensure NERL's licence obligations and corporate governance arrangements, taken as a package, meet the objectives set out in paragraph 2.19, ensuring that NERL maintains sufficient financial and non-financial resources to conduct its regulated activities, and that it avoids exposing en route airspace users to unacceptable risks arising from NATS' activities outside the regulated business. The ring-fence conditions are, therefore, intended to prevent difficult to predict events whose probability may not be high and, as such, form, an important part of the regulatory framework which is designed to protect consumers' interests. As part of this, the CAA should be given direct assurance to confirm that the appropriate policies and procedures are in place to achieve this outcome.
- 3.2 The CAA's review of the existing governance and ring-fencing arrangements found that there are a number of areas in which the ring-fence and associated conditions in NERL's licence do not give the CAA the level of oversight and comfort that it requires in order to ensure that stakeholders and consumers are adequately protected.
- 3.3 In addition, it is clear that the current licence conditions are significantly less robust than those prevailing in other regulated sectors and are, in many respects, an 'outlier' of regulatory practice. For example, requirements for regulated company boards to contain independent directors (sometimes as the largest group) are common to the gas, electricity, water, rail, health and financial services sectors, each of which undertakes activities of national importance, are of comparable significance to consumers and, in some cases, also affect their safety. NERL does not, at present, have an obligation to have independent directors on its board of directors.
- 3.4 The CAA considers that any new obligations need to be designed in a manner that ensures that they work in conjunction with one another and with other licence conditions, such as those in respect of regulatory accounts. In practice, this is likely to require the regulatory regime to ensure and deliver the following outcomes:

- appropriate mitigation of any risks and conflicts of interest faced by the boards of NERL and NATS Holdings, the parent company of the group;
- a management of NERL that is sufficiently focussed on that business rather than the broader interests of the NATS group so that risks are not traded off between NSL and NERL;
- that the apparent culture of regulatory compliance within NERL can be easily observed by the CAA and maintained in the future;
- protection for the funds provided (indirectly) by consumers through NERL's regulated revenues for the benefit of the regulated business;
- sufficient transparency for the CAA as to the ongoing financial and operational robustness of NERL; and
- clarity and lack of ambiguity in NERL's licence obligations, so that the licence can apply with as little as possible need for consents or comfort letters.

3.5 In order to deliver these outcomes, the CAA has identified a range of potential changes to the governance and ring-fence arrangements of NERL that could address these problems and bring the regulation of NERL more into line with best practice observed elsewhere. These options are considered further in the following chapters.

Objectives of any proposed licence amendments

3.6 The CAA considers that any proposed amendments to NERL's licence should be assessed in the context of an overall objective of ensuring that the regulatory arrangements for NERL remain effective and appropriate. Regulatory obligations should be viewed as an interlocking set, which complement and support one another in the interests of consumers. The appropriateness of these rules also needs to be assessed in the context of:

- the changes to the economic and regulatory landscape that have happened in the period since the financial crisis began in 2008 and referred to in The Executive Summary and Chapter 2;
- the commercial activities of the wider NATS group and the impact on the risks affecting NERL that those activities may have;

- developments in regulatory best practice as evidenced by the arrangements used by other regulators, while being mindful of the differences between regulatory sectors;
- the need to ensure the efficacy and clarity/lack of ambiguity of the existing obligations which NERL is required to comply with (and associated compliance costs through the need to make difficult judgment calls on compliance); and
- the need to impose obligations that are “necessary or expedient” to allow the CAA to fulfil its statutory duties while imposing on licence holders the minimum restrictions or burden consistent with the exercise of those functions.

The role of consents

3.7 In this context, the CAA’s aim is that the relationship between NERL and the CAA should be governed, as far as possible, directly by the obligations set out in NERL’s licence and that, other than in exceptional circumstances, the licence should operate without the need for consents or comfort letters.

3.8 As such, we consider that, while there is a place for consents to be given to allow NERL to gain derogation from some licence conditions (in whole or part), where possible the licence should be simplified so that less regulatory intervention is needed. The issue of consents should be restricted to those circumstances in which it is truly needed, rather than to provide general comfort to NERL or its financiers.

Areas identified for strengthening the licence obligations

3.9 The CAA’s analysis has identified potential to amend NERL’s licence in a number of respects which would better achieve the objectives set out in paragraph 2.19 above.

3.10 The CAA considers that these changes fall into four broad categories:

- corporate governance (what governance will ensure that the interests of safety and consumers are adequately protected?);
- information (what additional information/certification could NERL provide to support the objectives set out above?);

- protection (how can licence conditions ensure that both safety and users interests are protected by buttressing the financial stability and continued operation of NERL?); and
- simplification (can the rules set out in the licence be made easier to comply with and enforce?).

3.11 These issues are considered further in the following chapters.

Chapter 4

Development and assessment of initial proposals on Governance

Existing arrangements

- 4.1 Since NERL's licence was amended in 2007 to remove reference to the Code of Corporate Governance³, the CAA has not sought to set standards for Board leadership and governance for NERL, in part, in the light of the structure put in place at the time of the PPP. Instead, the CAA has 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.
- 4.2 However, since these obligations were introduced, the world of corporate governance, and the regulatory oversight of it, has changed as discussed in the Executive Summary and in Chapter 2.
- 4.3 Many regulators have already reviewed or enhanced the regulatory oversight of corporate governance in other sectors in recent years. These rules have been introduced without affecting the ability of the owners of the business to be represented on the board of the regulated company or to exercise their ownership rights.
- 4.4 In this context, it should be remembered that there is an inevitable asymmetry of information between any regulator and the company it regulates. One of the effects of this is that the regulator may not get adequate early warning of the onset of financial distress, especially if the management in place at the time take the view that either the financial distress can be managed or that they have no direct obligation to keep the regulator informed. We do not here attribute or predict any bad faith on the part of management, but nevertheless consider that the regulator may not be fully aware in "real time" of the onset or extent of any financial distress on the part of a company it regulates. This information asymmetry is exacerbated to the extent that sub contractors are used to deliver key parts of, or facilities for the use of, the regulated business.

³ The UK Corporate Governance Code (formerly known as the Combined Code) is a set of principles of good corporate governance aimed at companies listed on the London Stock Exchange.

Issues identified

- 4.5 The Ad-Hoc Review and the CAA's subsequent work has identified that there are weaknesses with the corporate governance of NERL that could lead to consumers' interests being harmed. In particular, the Board of NERL does not contain any non-executive members (unlike the NATS board) and, although the composition of the NERL and NATS board is not identical, board meetings of NERL are "nested" within the board meetings of the NATS group. Each of these elements of NERL's board governance makes it more likely that, especially at times of financial or other difficulty, the members of the board of NERL are at risk of becoming exposed to conflicts as a result of duties they hold as members of the boards of other companies within the NATS group and/or may not be able to properly protect NERL from conflicting interests of NATS.
- 4.6 The CAA's analysis found that the structure of the PPP is complex as it was designed primarily to manage the interests of the various shareholders. As a consequence, the CAA considers that the existing structure of the NATS group does not adequately ensure sufficient focus on the activities of NERL by its board (and, through the regulatory obligations set out in NERL's licence, the interests of consumers as opposed to any other group), again, creating a risk of conflicts of interests in relation to the other activities of the group. In particular, the structure of the PPP may lead to confusion over the governance of NERL for the following reasons:
- while there are requirements within the PPP for the directors of NATS Holdings to comply with the Combined Code on Corporate Governance, these obligations do not apply to NERL;
 - the non-executive partnership directors of NATS Holdings appointed by the DfT to represent the financial interests of the government do not *per se* have any role to ensure regulatory compliance by NERL;
 - the non-executive members of the NATS Holdings board, although they represent the shareholders, are 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; and

- the focus of NERL's board governance is potentially compromised by its board meetings being 'nested' within NATS group board.
- 4.7 As a result of these factors, there is the possibility that the board of NERL could become confused or conflicted by the duties that they hold to the other members of the group of whom they are also directors.
- 4.8 Consequently, it appears that they may be less likely than directors who are focussed solely on the interests of NERL to take decisions regarding the business of NERL and its compliance with its obligations in a manner that clearly and transparently focuses solely on the business of NERL. While, in ordinary trading conditions, this may not be an issue, in times of financial difficulty for NATS, NSL or NERL, any lack of focus on the interests and activities of NERL is all the more likely to come to the fore. While the probability of this may not be high, the impact of it may be very significant, prejudicing the ability of NERL to carry on its activities in an appropriate manner.
- 4.9 It might be asked whether the interests of NERL could ever really diverge from those of the wider NATS group. We have considered whether the risks affecting NERL are separate from those affecting NATS. Our view is that, in plausible situations, the interests of NERL and NATS may indeed diverge. However, due to the fact that we do not regulate NATS parent company or its other subsidiaries and the information asymmetry referred to above, the CAA will not necessarily have sufficient sight of when such a scenario might in fact be emerging.
- 4.10 For example, while NATS other operating subsidiary, NSL, is significantly smaller than NERL, if it were to get into difficulties, it is possible that this could have an impact on the stability of NERL directly or indirectly. This is because:
- there are significant cash flows between NSL and NERL in relation to the intercompany charges. If NSL were to get into difficulty, these would be affected and this could have an effect on NERL;
 - there are also cash flows between NSL and NATS which fund central costs in part - if these were to dry up on NSL getting into difficulty, these central costs would have to be borne by NERL; and
 - clearly, if NSL were in difficulty, 1 and 2 could occur at the same time, compounding this effect.
- 4.11 If, for example, NSL were to lose a number of TANS contracts in quick succession or was subject to significant legal action (perhaps through incurring an unlimited contractual liability), NSL might be destabilised quite

quickly. If this were to be the case, NATS might choose, for example, to change the terms of the arrangements between NSL and NERL/NATS, to make them significantly more favourable (while still being on an arm's length basis and normal commercial terms and therefore notionally licence-compliant). This could include changing the reconciliation terms so that cash stayed with NSL. It appears that this could be done within the group without the CAA having sight of it as there is no obligation in the licence for it to do so.

- 4.12 Similarly, the dividend policy of NERL (not NATS, whose policy is in part covered by the Partnership Agreement) might be changed to become more aggressive and this might also cause issues, especially if a prolonged airspace closure event happened (a credible, if rare, scenario).
- 4.13 The CAA has observed examples of circumstances which, if repeated in more extreme form, might give rise to financial difficulty for NERL and NSL both collectively and individually. In particular, the recent loss of TANS contracts by NSL in respect of Birmingham and Gatwick airports may be seen as an indicator that NSL operates in a market which is subject to market conditions, while NERL is a regulated monopoly. These differences make it clear that these two companies' interests may diverge. Other circumstances in which financial problems in the group may also emerge, for example in relation to significant disturbances in the bond market at a time at which debt finance arrangements needed to be renewed, so raising the same kinds of issues.
- 4.14 While the probability of each of these events might, individually, not be high, the impact of them on the group and the financial stability of NATS as a whole, NERL or other members of the group could be very significant and lead to the interests of individual companies within the group diverging. This may have a very significant impact on consumers, especially if NATS were to fail. This which might lead to the kinds of harm to consumers outlined above.
- 4.15 In addition, the structure of NATS creates a risk for NERL, inasmuch as NATS may decide to focus its corporate energy (and that of its most able staff) away from NERL. This is an internal matter of which the CAA would not have clear line of sight, but which could create risks for consumers. Improving the governance arrangements of NERL may help provide some safeguard against this by providing an independent voice which could identify such concerns and challenge them.
- 4.16 In this context, it should be noted that the protection of consumers' interests through regulatory oversight can be seen to have three pillars:

monitoring, effective ring-fencing and enforcement. In an ideal regulatory regime, each of these pillars would be of equal strength and effectiveness.

- 4.17 In relation to monitoring, while the CAA is able to monitor aspects of NATS's performance through the reporting requirements on NERL (especially in relation to its gearing ratio), there remains a limit to transparency, for example, because:
- NERL is not a listed company with the effect that less information is in the public domain; and
 - NERL is embedded within a wider business (NATS) that is itself controlled through a Public-Private Partnership ("PPP").
- 4.18 Furthermore, in the context of the regulatory regime applicable to NERL, the enforcement pillar is arguably weaker than it is in other regulated sectors, since:
- the regulatory regime under the Act does not provide for the imposition of financial penalties or the investigation of past breaches of licence, lowering its disciplinary effect on NERL;
 - even if fines were available as a tool of regulation, it is not clear how effective they might be at times of financial stress; and
 - the threat of sanctions against individual directors only applies where the directors have breached their duties, while risks to consumers may arise without this happening (as described above).
- 4.19 As a result, it appears that enforcement action is less likely to act as a significant deterrent to NERL or its directors from breaching their regulatory obligations than it does in other sectors, and is less likely adequately to drive a culture of compliance within NERL. These features of the regime would become especially evident if the Board were to be faced with pressure from its holding company or the shareholders in a time of deteriorating financial health.
- 4.20 While the interests of the current shareholders may, at present, be broadly aligned with the interests of NERL generally, we also take the firm view that the regulatory regime and rules applicable to NERL need to be agnostic as to the ownership of the company and future proof against any changes in ownership that may take place. This is particularly so because the statutory regime makes imposing more onerous governance requirements on a new owner a potentially time consuming and difficult process if the new owner were to wish to resist these changes.

NATS views

- 4.21 In relation to the CAA's proposals for NERL to appoint one or more independent directors to the NERL Board, NATS has told the CAA that the PPP created extensive checks and balances in the corporate structure of NATS Group, especially the defined roles of Strategic Partner, Government and the Partnership Directors.
- 4.22 Further, NATS said it was unclear how an additional tier of governance could be inserted without adding more complexity, disrupting the current checks and balances and so fundamentally altering the nature of the PPP. More generally, NATS questioned how such change would be either proportionate or aligned with the CAA's duty to avoid unnecessary restrictions on NERL.
- 4.23 NATS considers that the current governance arrangements are adequate on the basis of the CAA's confirmation that there is no evidence that NERL has failed to respond effectively to its regulatory governance requirements currently or in the past.
- 4.24 Instead, NATS has suggested that the CAA's concerns could be addressed in different ways including by:
- developing the annual Condition 5 certificate (regarding the adequacy of resources) to include a supplement describing the main evidence that NERL relies upon in providing the certificate;
 - expanding the terms of the NATS Audit Committee to include explicit scrutiny of the evidence base in support of the provision of the certificate;
 - providing the CAA with ongoing visibility of NERL's business risk management processes including updates for any material changes; and
 - reporting of the relative size of regulated and non-regulated activities in Board approved plans of the company along with annual details of transfers of seconded staff from NERL to NSL and vice versa.

CAA Assessment

- 4.25 As described above, the work undertaken by the CAA has identified a number of weaknesses with the corporate governance of NERL that could lead to users' interests being harmed in the event of certain scenarios, whose probability of occurring may not be high but which would be likely to have a high impact.

- 4.26 In this context, it should also be noted, from the analysis that we have done, that the CAA's approach to oversight of the governance of NERL is now becoming an "outlier" in regulatory terms. For those reasons, it appears that it would be appropriate to revisit the issue of whether, and to what extent, the CAA should oversee the corporate governance of NERL, as the regulated company delivering the monopoly regulated service within NATS.
- 4.27 In that light, the CAA has considered and assessed a number options to improve the oversight of NERL's governance arrangements including by:
- introducing requirements for NERL's board to be focussed solely on the interests of NERL and contain independent members ranging from a single member to a majority of independent members;
 - introducing specific obligations around the conduct of NERL's board meetings to prohibit these being 'nested' within group boards and requiring that separate individuals be on each board;
 - requiring the NERL board to contain independent directors with sector-specific expertise, as is the case in the rail industry, or other specifications of "competence"; and / or
 - introducing a requirement for the CAA to be able to approve or remove directors.

Appointing mandated independent directors

- 4.28 The CAA takes the view that greater independent oversight will help to counterbalance any risk that NERL's board members may be tempted to work to objectives and strategies designed to benefit the whole business of NATS, rather than the regulated business of NERL, especially where the wider corporate group is experiencing financial distress. Changes to the Board requirements for NERL would help guard against such conflicts of interest arising, especially where directors sit on the Boards of more than one Group company (e.g. both NERL and NSL).
- 4.29 As indicated above, such conflicts might be precipitated or aggravated by a climate of financial distress although there may also be areas (such as in relation to the deployment of staff by NATS), where these issues may arise in the ordinary course of business. Furthermore, even though, as a matter of the PPP, NATS Holdings is subject to the UK Corporate Governance Code and the oversight of the NATS directors, NERL itself is not subject to that code (although it was prior to the changes to the licence in 2007). As other regulators have found, the fact that the Code does not

apply directly to the licensed company means that it cannot be taken to act as a sufficient protection for the licensed company in relation to the position of its management within a wider group.

- 4.30 The appointment of independent board members is likely to drive higher standards of corporate governance generally. Our understanding of the way in which similar obligations have been implemented by companies in other regulated sectors indicates that companies faced with obligations to have independent board members are effectively driven to enhance the quality of their operating company board processes as these are necessary to support the participation of independent board members. These changes can also increase the focus on consumers' interests. This is particularly the case if, as a matter of practical reality, companies want to be able to attract credible high quality candidates into the roles. Our understanding is, however, that companies still retain significant flexibility and freedom to organise their internal structures and processes efficiently.
- 4.31 There is, of course, a risk that companies may perceive a requirement to appoint independent directors to their licensee boards as creating significant bureaucracy at the licensee company level (particularly if they perceive a need to reproduce all the main board committee structure at that level). However, the CAA considers that companies have significant scope to choose how they organise themselves and are not bound to take an approach that "over engineers" the licensee governance process.
- 4.32 At the same time, we consider that the licence should provide explicitly for the directors of NERL to focus on the interests of NERL.
- 4.33 In NERL's case, one of the effects of these changes would be that they could be expected to put an end to the "nesting" of NERL's board meetings within the wider NATS board meetings, even without specific regulatory intervention to prohibit it.
- 4.34 As discussed above, in part, the importance of independent directors may be at its peak in dealing with events whose probability may not be high, but which would be likely to have a high impact. We consider that one of the times when mandated independent directors may have the most influence is in challenging holding company behaviour in the acute stages of an incident causing financial distress.
- 4.35 In this light, it appears that there is a strong case for a change to the regulatory rules to which NERL is subject and to mandate NERL to appoint a number of independent directors to its board and that the directors should act solely in the interests of NERL. In doing so, we consider that implementing such a change would not impose an undue

burden on NERL.

- 4.36 In addition, we also considered whether NERL should be required to have a *majority* of independent directors on its board, or requiring them to be the largest group on the board. We considered, however, that this approach, although it has parallels in other sectors and would be effective in addressing our concerns about corporate governance generally, would not appear necessary in order to bring the benefits outlined above. We do, however, consider that more than one independent director should be appointed to provide mutual support in difficult circumstances and to ensure an independent presence at all times. This also implies that the board should not be considered quorate unless at least two independent members are present.
- 4.37 While we do not consider that it is appropriate (or necessarily in accordance with their duties as directors) to require the independent directors to have any formal responsibility or reporting line to the CAA, we do consider that NERL should be required to inform us of the departure of any such director (giving reasons). In addition, the CAA is of the view that such directors, should be free to discuss any matter with the CAA in appropriate circumstances.

Obligations around the conduct of NERL's board

- 4.38 We have also considered whether to introduce specific requirements for NATS to end the “nesting” of NERL board meetings within wider NATS meetings and to require different board compositions between NERL and NATS.
- 4.39 While the CAA considers that these options are not necessarily mutually exclusive with a requirement to have independent directors, our assessment suggests that introducing specific obligations around the conduct of NERL's board meetings would only be partially effective to address the concerns identified. While it would address particular “symptoms” of our concerns, it would be too invasive in terms of not allowing NERL and NATS the freedom to arrange the administration of their corporate affairs, including the deployment of executive directors, while not delivering the same level of benefit as independent directors.

Expertise

- 4.40 We also considered whether there should be a requirement for the Board to contain independent directors with specific expertise, as is the case in

the rail industry. We considered that this approach, while it might add to the effectiveness of the proposals, was not necessary in NERL's case, as the board oversight we are looking to promote is general in character. In addition, we consider that this approach would unnecessarily reduce the size of the candidate pool and increase costs for NERL in finding and attracting appropriate board members. In any event, we considered that it should be for NERL to choose and appoint the directors, without requiring CAA approval, in accordance with independence criteria set by the CAA.

- 4.41 We do however consider that appointed directors should have competence and experience commensurate with the non-executive role in a company like NATS. For instance, they might have fulfilled a similar role in the past, and should have sufficient business experience to appreciate the in-the-round implications of corporate actions. We therefore envisage an obligation that the mandated independent directors should be "competent", with the CAA perhaps giving guidance to NATS as to the meaning of this word.
- 4.42 We also considered making NERL itself subject to the UK Corporate Governance Code, in a similar manner to the obligations placed on regulated companies in other sectors. However, we do not consider that this approach is proportionate or necessary. In particular, we consider that this would drive additional duplication of board committees and greater constraints on NERL's ability to organise its affairs in the most appropriate manner than are justified by any extra benefits this requirement would bring.

CAA approval of Board Members

- 4.43 Finally, we considered that requiring CAA approval of Board members is likely to be disproportionate and unnecessarily intrusive as it is for NERL's shareholders to choose and appoint directors without requiring approval or veto from the regulator.

Alternatives in lieu of independent directors

- 4.44 We also considered whether it would be appropriate to provide for the possibility that, while the "default rule" would be for NERL to have independent directors appointed to its board, the licence should provide for the possibility of NERL obtaining consent not to do so on the basis that appropriate alternative protections were in place. The possibility of obtaining such a consent does appear to be available in some other regimes, although we are not aware of any that have been granted.

- 4.45 While, at first glance, this option may be attractive as it would provide for NATS to develop alternative approaches to meeting the risks of potential consumer harm identified above, our current thinking is that adopting this approach does not appear appropriate for the following reasons:
- any such consent would need to be reviewed in the event of changes of circumstances. It might be possible for the licence to identify certain “fixed” points at which any consent would either automatically terminate (thereby requiring the appointment of independent directors or triggering the need to apply for a new consent) or be reviewed by the CAA. These might include material changes to the structure of NATS or changes to NATS’ shareholders. However, it does not appear to the CAA to be possible either to define an exhaustive list of the circumstances in which a consent should fall away or be renewed, or necessarily to be possible to define all such circumstances with sufficient precision (for example, the emergence of financial stress for NERL);
 - in any event, even if we were to be able to define the circumstances with sufficient precision, we would not necessarily be aware of when those circumstances were biting on NERL or necessarily be able to react in appropriate timescales (for example in relation to financial difficulties that came on suddenly);
 - the alternative would be to reserve a broad discretion for the CAA to withdraw any such consent. However, this is unlikely to provide sufficient certainty to be appropriate for a regulatory rule;
 - even if this approach were to be adopted, the termination of any consent (and consequent need to appoint independent directors) would take time to implement, which may divert management time away from the business of NERL at a time when it was most needed and also lead to there not being independent directors on the board of NERL at precisely the time when they were most needed; and
 - it is not clear to the CAA on what basis it would seek to determine whether the alternative arrangements proposed by NERL did indeed provide an equivalent level of protection to that provided by independent directors. Aside from anything else, this may lead to the CAA requiring protections to be put in place that were more onerous than appointing independent directors would have been.
- 4.46 For these reasons, it appears to us that this approach would add inappropriate regulatory and process risk and uncertainty and, therefore,

we do not currently consider it provides an appropriate alternative to the proposal to require independent directors to be put in place.

Conclusion

- 4.47 As stated above, the CAA sees significant merit in NERL's board containing independent members to ensure that the management of NERL is sufficiently focused on that business rather than the broader interests of the NATS group. The CAA considers that while a majority of non-executives would be effective in addressing our concerns, a more proportionate and less burdensome response would be to require the presence of a minimum of at least two independent and competent directors to bring the benefits required and reiterate in the licence that the directors of NERL should focus on the interests of NERL alone.
- 4.48 The presence of independent directors on these licensee boards can be expected to lead to those board becoming forums at which "real" board business is done (rather than being completely subordinated to the Topco board). This is particularly the case if those boards are to be able to attract credible high quality candidates into the roles and those directors are present for the board to be quorate.
- 4.49 In summary, the presence of independent directors on NERL's board may be expected to have a number of benefits:
- independent directors would be better placed to challenge any management decisions that prejudice the interests, or conflict 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 candidates 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; and
- the presence of independent directors can be expected to drive better corporate governance standards generally.

4.50 As a result, it appears that there is a strong case for a change to the regulatory rules to which NERL is subject and our initial proposal is to mandate NERL to appoint a minimum of two competent independent directors to its board, to set quorum rules as including these in decisions, and to reiterate in the licence that the directors of NERL should focus on the interests of NERL alone.

Chapter 5

Development and assessment of initial proposals on the financial ring-fence

Introduction

- 5.1 In the context of economic regulation, 'ring-fencing' usually refers to the various mechanisms that are used to functionally and/or structurally separate a firm's regulated operations from its non-regulated ventures.
- 5.2 As stated above, these rules ensure that the regulated revenues and assets of the monopoly business of the licensee are applied for the benefit of that monopoly business and not diverted to, or put at risk by, other activities of the licensee or the corporate group within which it sits. This is important for consumers and service users as it ensures that the regulated charges that they are required to pay are not applied to, or put at risk by, other commercial activities.

Implementing a ring-fence

- 5.3 Standards of conduct are a commonly used form of ring-fencing. Ring-fencing can also include a number of other specific prohibitions or obligations aimed at insulating a regulated company from the impact of activities undertaken by holding companies or affiliates. Therefore, for regulated businesses, ring-fencing is a very important component of a firm's governance.
- 5.4 The ring-fence conditions which are observed in sectors such as energy, water and rail generally form part of a wider range of measures that seek to prevent or address the consequences of regulated companies getting into financial difficulties. In particular, the regulator in each of these sectors has a duty to ensure that companies can finance their licensed activities.
- 5.5 Additionally, the relevant legislation in these industries contains provisions for companies to be placed into a special administration regime. Special administration differs from normal insolvency processes primarily through the requirement for the Administrator to seek to maintain the operation of the business alongside considering the interests of creditors, rather than having a sole responsibility to consider the interests of the creditors. In relation to air traffic services, the special administration regime is known

as an “Air Traffic Administration”.

- 5.6 As a minimum, therefore, regulatory ring-fencing could be seen as providing early warning to the regulator that a company may be entering, or is in, financial difficulties that require action to be taken. Through early warning the regulator could then make more informed decisions about what, if any, action to take. Going beyond this, financial ring-fencing is also intended to reduce the degree of harm that occurs to users as a result of a company getting into financial difficulties. Depending on the circumstances of the industry, the regulator might structure the arrangements with the aim of limiting harm to users or by ensuring that there is no harm to users.

NERL’s ring-fence

- 5.7 The existing NERL licence contains various ring-fencing conditions that, in principle, are aimed at protecting the regulated business from risks arising in the wider NATS group. Therefore, if financial or operating difficulties arise in, say, NSL, the regulated business should remain resilient. These conditions are similar but not identical to those adopted in other regulated sectors.
- 5.8 The principal elements of the existing NERL ring-fence are set out in ‘Licence Condition 5: availability of resources and financial ring-fencing’ and include requirements for NERL to⁴:
- ensure it has sufficient resources to perform its obligations;
 - limit the scope of activities undertaken which are outside of the regulated business;
 - create a financial ring-fence around the regulated business;
 - make the CAA aware of any material changes to its financial arrangements;
 - notify the CAA of events which might prejudice its financial stability;
 - restrict the disposal of relevant assets;
 - restrict the level of debt it can incur;
 - require the ultimate holding company to undertake not to cause NERL to breach the Licence;

⁴ Full details of the licence requirements are set out at: <http://www.caa.co.uk/docs/5/20150101NERLLicence.pdf>

- refrain from entering into any agreement with an affiliate except on an arm's length basis on normal commercial terms;
- maintain an investment grade credit rating; and
- establish a financial gearing target and cap.

5.9 In addition, Condition 9 'Prohibition of cross-subsidies' reinforces the effect of the ring-fence by ensuring that there are no cross subsidies between related parties within the NATS group that could lead to leakage of funds or assets into or out of the ring-fence. As stated above, this ensures that regulated revenues are applied to the regulated business, and ensures that the Price Control has its proper regulatory effect of controlling the revenues, and funding the activities of the regulated business. Condition 17 'Provision of information to the CAA for regulatory purposes' is also relevant to this discussion as it enables the CAA to obtain the information it requires to ensure compliance with the licence obligations.

Issues identified

5.10 From our assessment, the CAA has concluded that the existing financial ring-fence may not, in its current form, be sufficiently robust to achieve our stated strategic outcome of ensuring that NERL maintains sufficient financial and non-financial resources to conduct its regulated activities and that it avoids exposing users to unacceptable risks arising from outside the regulated business. In particular:

- the reporting and certification of resources obligations in the licence do not provide the CAA with sufficient transparency over the ongoing stability of the business including whether it is operating effectively in accordance with its obligations. In particular, the certification obligation at present requires the directors of NERL to give a single certificate in relation to both financial and operational resources. We consider that this dilutes the effectiveness of this certificate because it does not ensure that the licensee has sufficient focus on each of its financial and operational risks;

- while NERL provides an annual certificate that it has sufficient resources to continue operation for the next two years, it does not have to explain how it reached this conclusion nor the factors it has taken into account in providing the certificate. As such (and especially in relation to operational risks), the CAA has no visibility as to how the directors came to the decision to give the certificate in question. The CAA therefore does not, as a matter of course, get sufficient information about the internal processes of NERL in order to allow it to make any kind of assessment of the appropriateness and effectiveness of those systems. This has an adverse effect on its ability to regulate and, consequently, on the level of protection given to stakeholders and consumers through the regulatory regime;
- NERL currently has no obligation to certify compliance with specific licence obligations prior to declaring a dividend or other distribution of capital. Such a requirement is a feature of a number of licences observed in other regulated sectors. As such, the ring-fence does not drive a culture in which compliance with the obligations set out in the licence is considered regularly by the board;
- Some of the obligations in the licence (for example in relation to cross subsidies) are insufficiently clear either for NERL to comply with them easily, or the CAA to oversee and enforce them; and
- NERL does not have any plans in place to provide appropriate assistance to an administrator in the event of it entering an Air Traffic Administration.

NATS views

5.11 In response to a request from the CAA, NATS has provided a detailed description of the processes and procedures it has in place to ensure that it complies with the financial ring-fencing obligations of its licence. These processes form part of the company's regular planning, forecasting, reporting, commercial, governance and control environment and, for example, include controls such as:

- pricing intra-company contracts on a commercial arm's length basis taking into account risks and transfer pricing guidance;
- contractualisation of inter-company arrangements using greater than 12 month notice requirements where services are provided to NERL;
- measures to avoid large inter-company balances being built up; and

- express provision recognising the operation of TUPE to transfer staff from NATS to NERL.
- 5.12 NATS considers the existing arrangements to be fit for purpose and has not been able to identify any example of CAA concerns about the interface between NERL and NSL that could be resolved in a proportionate or targeted way by extra compliance certification obligations. As such, NATS does not consider that any further requirements would provide additional value to users.
- 5.13 NATS has said that it does not have an intervention plan specifically designed for an administrator because it considers that the plan followed by the administrators would depend on the individual circumstances of the case. It does, however, consider that it could create a “directory” to existing repositories of key information which it could keep under review annually.

CAA assessment

- 5.14 Notwithstanding what NATS has told us about its systems and processes, the CAA does not have sufficient ongoing oversight of the activities of NERL in order to gain assurance that NERL is complying with its obligations in relation to the ring-fence and that it has sufficient resources available to it on an ongoing basis.
- 5.15 On the financial ring-fence, the CAA has considered and assessed a range of additional certification and reporting obligations for NERL to deal with the problems that have been identified, to increase transparency and certainty on the part of NERL, and to ensure that the CAA is provided with an appropriate level of information and assurance by NERL as a matter of course on an ongoing basis. These can be summarised as follows:
- re-focussing NERL’s annual directors’ resources certificates to give additional clarity to and emphasis on operational as well as financial resources by requiring separate certification of financial and operational resources;
 - requiring the certificates to be supported by statements from the Directors setting out the processes used and the factors considered in issuing them;
 - requiring new certificates from NERL’s directors to confirm that the licensee has complied with specific elements of the ring-fence i.e. the obligation not to enter into cross-defaults, not to give or receive cross-subsidies and to comply with information requests;

- introducing a new requirement to re-state these certificates of compliance before declaring a dividend;
- requiring NERL to maintain an intervention plan to assist a administrator in the event of it entering an Air Traffic Administration; and
- introducing changes to the rules which 'lock up' cash within NERL in the event of certain additional signs of financial stress appearing (for example in relation to breaches of banking covenants, failure to certify sufficient resources or actual/potential downgrade of the credit rating).

5.16 Each of these options is considered in greater detail below.

Giving greater emphasis to operational resources

5.17 Strengthening the certification requirements to place greater emphasis on operational resources would appear to be relatively straightforward and would not, in its face, require significant additional work from NERL in order to be able to comply. Rather, we consider that it would ensure that there is focussed consideration of whether the regulated business has sufficient resources in order to carry out the regulated activities on an ongoing basis. Furthermore, as indicated above, we consider that it would give CAA greater and more specific assurance.

5.18 We have considered a lighter touch approach of leaving the existing certification requirements in place, but, for the reasons set out above, we consider that this approach was not appropriate.

New statement of processes and factors considered

5.19 Requiring NERL to provide us with a statement of the processes and factors that it has used in producing its resources certificates would give us greater and more specific assurance of the matters that the NERL Directors have considered in providing the certificate. At present, the CAA has no ongoing assurance that the processes that NERL uses are robust or fit for purpose (as the licence requires them to be). The only annual assurance that the CAA obtains is from the auditors, and then it is only "negative" (in that it seeks to identify inconsistencies with the accounts) and it is only produced by reference to their audit.

- 5.20 As a result, we consider a new requirement to provide statements of this nature will provide greater transparency as to the manner in which the certificates are prepared and give the CAA material comfort that the licensee is using appropriate tools in order to assess whether it does indeed have the required resources. This will, in turn, give the CAA and stakeholders greater confidence in the certificates of sufficiency of resources that the licensee is required to give.
- 5.21 While this is a requirement that was removed from NERL's licence in 2007, it appears that the present approach is now an outlier in terms of regulatory oversight and, in the context of the developments referred to in the Executive Summary and Chapter 2, the present very "light touch" approach is no longer appropriate. By contrast, gas and electricity network licences require the Directors to explain the factors that they have considered in giving the certificate. Our understanding of the operation of these rules indicates that it will not be particularly onerous for NERL to be required to set out for the CAA what the relevant factors are, especially since they are already required by the licence to have the underlying processes in place.
- 5.22 In addition, this approach would limit the need for the CAA to ask for this information in relation to particular certificates (as it previously has done) and would increase the CAA's oversight of NERL's financial and operational robustness without increasing the regulatory burden on NERL. In short, NERL would be required, not only to have the relevant procedures in place, but to explain what they are to the CAA.
- 5.23 We consider that this would have the added benefit of turning the Directors' minds to these issues in a more detailed manner at least once a year. As a result, it can be expected to improve the culture of risk management and compliance within the licensed business.
- 5.24 For the reasons set out above, while we did consider leaving the regime as it is and not requiring this statement, we do not consider that this approach would be appropriate. By contrast, while we did consider extending the requirement for the auditors to provide additional assurance, we considered that this approach would not be proportionate, since it would be likely to lead to a more intrusive (and expensive) audit process and would lead to NERL being faced with additional costs in relation to the preparation of that report from the auditors that would not be proportionate in relation to the additional benefit that it would bring. Indeed, especially if the new certificates are required to be signed by one of the independent directors that we are proposing should be appointed, we consider that the new governance arrangements should provide

sufficient comfort for the CAA that these statements are robust.

Certification of compliance

- 5.25 Having reviewed the ring-fence, we consider that it would be very desirable for NERL to be required to provide certificates to the CAA that it has complied with the ring-fence and associated conditions on a regular basis – at least annually and prior to dividend payment decisions.
- 5.26 The CAA considers that any new compliance certification of this kind would cover licence conditions 5, 9 and 17 to ensure that NERL is certifying compliance with each of the conditions that comprise the financial ring-fence as well as any formal information requests that the CAA has issued to NERL.
- 5.27 We consider that the use of compliance statements such as these is a helpful tool in ensuring that issues of compliance are treated with the appropriate level of importance by not only the board of NERL, but the entire NERL business. Such compliance statements are a feature of network licences in other regulated sectors. Their purpose is to make the licensee think about whether it is complying and to have the board of directors consider compliance on a regular basis. If the company does this properly, then the compliance regime within the business should be appropriately designed to enable the board to give a clean certificate. This will necessarily involve consideration of the robustness of those procedures by the board which ensure that compliance issues are driven appropriately at all levels of the business. The CAA considers that the burden of these reporting obligations is low given that the company should have appropriate systems and processes in place to comply in any event.
- 5.28 Furthermore, this would increase the profile of those obligations within NERL and would provide the CAA with more comfort that the Directors have given this issue appropriate consideration on at least an annual basis. As with the resources certification requirements we are proposing, if the new certificates are required to be signed by one of the independent directors that we are proposing should be appointed, we consider that these certificates will provide significant comfort to the CAA that NERL is complying with its obligations.
- 5.29 We also considered leaving the rules in place as they are. However, for the reasons set out above, we consider that the additional comfort that these certificates will bring should provide additional assurance to the CAA and consumers that NERL is complying with its obligations without imposing any significant administrative or financial burden on NERL.

- 5.30 By contrast, we considered as well whether it might be appropriate to require NERL to appoint a compliance officer and provide detailed compliance reports to the CAA annually, in a manner similar to that required in other sectors. However, we considered that this approach would be unnecessarily onerous in the context of NERL at this time and that it should not be pursued.

Re-stating certificates of compliance before making dividend decisions

- 5.31 As part of our consideration of whether to require NERL to provide compliance certificates annually, we also considered whether it would be beneficial to bolster this with a requirement to re-issue the certificates prior to NERL's board making decisions about dividends.
- 5.32 Having considered this, the CAA considers that this would provide clear benefits for users in terms of regulatory oversight and promoting a compliance culture. The payment of dividends can be considered as a significant milestone event for the company and requiring the Board to consider whether the compliance arrangements NERL has in place remain fit for purpose would sharpen focus on the requirements of the licence within the business.
- 5.33 We do, however, consider that requiring re-statement of these compliance statements if the dividend is declared less than six months after the last annual statement would be an unnecessary burden on the licensee that would add very little in terms of additional meaningful oversight for the CAA. As a result, we propose that this certificate will not be required if the declaration or recommendation of a dividend falls six months or less after the last annual compliance statement.

Maintaining an intervention plan

- 5.34 Introducing a new requirement for NERL to maintain an intervention plan to assist an Air Traffic Administrator in the event of insolvency would be consistent with the CAA's regulation of airports as well as the approach adopted by regulators in other sectors. The CAA considers that such a requirement would bring significant benefits in terms of mitigating the impact of insolvency by providing key information to an Air Traffic Administrator about the processes and services necessary to keep the business running.
- 5.35 Having said that, we are concerned to ensure that the manner in which this obligation is implemented does not impose an undue burden on the

licensee. As such, we are concerned to ensure that it is straightforward for NERL to keep its records consistent and up-to-date.

5.36 As a result, we propose that the obligation to maintain an intervention plan could be met by NERL effectively keeping an “index” or “directory” of where the relevant records are to be found, in order to ensure that this burden, and the attendant risk of inconsistency of records between those in the intervention plan and those that the business actually uses does not arise. This approach should also make compliance more straightforwardly achievable by NERL since no substantive new records will need to be created. On this basis, we consider that the information that NERL should be required to index should be reasonably extensive and include NERL’s:

- financial assets, resources and facilities;
- non-financial assets, rights and resources, including information on key management and operational personnel and information technology systems;
- liabilities, including contingent and contractual liabilities with counterparty and maturity information;
- tax affairs;
- personnel (including any personnel employed by other members of its group who are engaged in operating any aspect of its business);
- pension schemes (including any sponsored or administered by members of its group);
- mortgages, charges, or other forms of security over the NERL’s assets;
- systems and processes by which NERL carries on the En route Businesses including information on significant contracts;
- arrangements under which the NERL has delegated any part of the En route Businesses to a group company;
- contractual rights to receive cash or other financial assets;
- contractual obligations to deliver cash or other financial assets; and
- arrangements and procedures for ensuring compliance with its regulatory obligations.

5.37 We consider that this is the information that an Air Traffic Administrator would need to have available in the event of his appointment and therefore is the appropriate scope of this obligation. However, as said

above, in order to mitigate the burden of this obligation, we consider that compliance can and should be achieved by creating an “index” rather than a “filing cabinet” of this information.

Simplification of the prohibition against cross subsidies

- 5.38 Condition 9 of the licence imposes a prohibition on NERL’s En Route business giving or receiving a cross subsidy from any other business of NERL or the wider NATS group where such cross-subsidy has or is intended to have the effect of preventing, restricting or distorting competition in any market for the provision of air traffic services.
- 5.39 Prohibitions on the giving or receipt of cross subsidies by regulated monopoly businesses are common features of regulatory licensing regimes and have the effect, among other things, of ensuring that the regulated monopoly revenues of the regulated business (and the assets and staff that they pay for) are applied for the use of those businesses and not for other purposes.
- 5.40 The purpose of Condition 9 is not to prevent the provision of services between companies within the NATS group. Rather it is to ensure that when such services are being provided they are transacted on normal, commercial terms thus preventing the regulated business from unfairly subsidising unregulated businesses, for example, by unjustifiably absorbing costs which rightly belong to those other businesses or activities. As such, these rules not only bolster the financial ring-fence, but also support the price control settlement, which is designed to finance the en route businesses of NERL, not other activities.
- 5.41 While the drafting of the condition when the licence was issued may have been an attempt to ensure that this provision was not unduly onerous, we consider that the “secondary test” relating to the effect on competition is no longer appropriate for the following reasons:
- as currently drafted, this prohibition effectively only operates in one direction because it applies a test of preventing, restricting or distorting competition. NERL (as a natural monopoly) by definition is unlikely to receive a cross-subsidy which prevents competition whereas NSL (which operates in a competitive market) can;

- issues of cross subsidy which affect competition can be dealt with by competition law as potential abuses of a dominant market position. Competition law enforcement provides the CAA with the ability to use sharper remedies than the present licence enforcement tools;
- to the extent that NERL's behaviour created competition issues, the CAA would be required to consider using its competition law powers, if appropriate, ahead of using licence enforcement powers; and
- we do not consider that this secondary test provides a benchmark against which it is particularly easy to assess compliance, either from NERL's perspective in ensuring that its activities are legitimate, or from the CAA's perspective, given the economic analysis that would be required to answer questions raised under this test.

5.42 In addition, NATS has informed us that it operates an activity based costing system to allocate costs appropriately. Further, NATS referred to the CAA's external consultants' recent review that concluded that this system was fit for purpose and that the processes around it appeared robust.

5.43 On this basis, we consider that if the secondary test in paragraph 1 of Condition 9 were to be deleted, the anomaly referred to in the first bullet point of paragraph 5.41 above would be removed and the application of the cross-subsidy prohibition would be simplified.

5.44 Crucially, we do not consider that this approach would prohibit the flow of services between the various NATS group companies, or the use of shared facilities by them. Indeed, it should be made clear that the CAA does not consider that the use of shared resources by NERL and its affiliates and related undertakings would be regarded as creating a cross subsidy between NERL and any such affiliate or related undertaking, where:

- the costs of those resources are shared between on an arm's length basis and normal commercial terms; and/or
- the costs of those resources are accounted for in accordance with the Regulatory Accounting Guidelines prepared by NERL in accordance with Condition 6 (Regulatory accounting requirements) of its licence.

5.45 On this basis, we consider that this secondary test could be removed from

the licence without adverse impact on NERL.

Conclusion

- 5.46 These reporting and certification of resources obligations of NERL would provide the CAA with sufficient transparency over the ongoing stability of the business and that it is operating effectively in accordance with its obligations. Stronger reporting and certification arrangements are also likely to be made more effective by the improved governance arrangements set out in the previous chapter.

Chapter 6

Areas we do not propose to change

Introduction

- 6.1 As part of our review, we have considered a number of other options proposed by the ad-hoc Board group on NATS risks (January 2013) and as a result of our additional work. Some options have now been eliminated as being disproportionate, impractical or overly intrusive. Financial ring-fence options eliminated include changes to the cash 'lock up' rules, novating staff from NATS Ltd to NERL and NSL and cross default obligations.

Extending the cash lock up

- 6.2 We have considered whether the existing rule, in which NERL is prohibited from declaring or paying a dividend (among other things) if it exceeds a gearing ratio of 65% should be replaced or augmented by inserting additional triggers for cash lock up into the licence in the event of:
- the directors not giving the CAA a "clean" sufficiency of resources certificate; and
 - NERL losing its investment grade credit rating, or it having a credit rating that was at the lowest level of investment grade, but being on watch for downgrade.
- 6.3 The cash lock up provisions were considered by the CAA at the time of the CP3 price control, at which time the present cash lock up regime was implemented. Having reviewed the decision that the CAA made at that time and additional information provided by NATS, the CAA is of the view that the existing arrangements provide adequate protection to consumers and that extending the cash lock up provisions in the manner described above would not provide any additional protection to consumers, while potentially increasing NERL's financing costs, to consumers' detriment. In particular, it appears that the present cash lock up provisions imply a credit rating that is significantly higher than that currently required by the licence and, therefore, the present rule affords greater protection than a cash lock up related to credit rating would. The licence also requires NERL to provide information to the CAA concerning its levels of gearing, which provides forward looking protection as well as limits on the "present

state” of NERL’s finances.

- 6.4 As such, and given the need to maintain stability in relation to the financial obligations to which NERL is subject in order not to have an adverse impact on its present financing arrangements or its ability to finance its activities in the future, the CAA considers that the current cash lock up arrangements remain fit for purpose and robust in the circumstances facing NERL. We do not, therefore, believe that any change in this area is justified.

Employee arrangements

- 6.5 One issue that we considered merited further investigation as part of the Ad-Hoc Review was the employment issues surrounding the staff employed in the NERL business. In particular, we were concerned to understand the arrangements in order to be satisfied that NERL would continue to have access to sufficient personnel in the event of insolvency affecting NATS Holdings or other group companies.
- 6.6 To assess these issues, we obtained specialist legal advice and also consulted with NATS in order to understand what the likely impact of various insolvency scenarios might be. This analysis indicates that:
- as NATS Holdings is a pure holding company, the insolvency of this holding company is unlikely to create issues for the employee arrangements;
 - in the event of an insolvency of NATS Limited, if no alternative management services were put in place, the employees who work exclusively for NERL would be transferred to NERL under the TUPE process;
 - in the event of an insolvency of NERL, the employees who work exclusively for NERL would be likely to transfer to any new provider to whom the NERL business was sold as part of any Air Traffic Administration; and
 - in the event of an insolvency of the entire group, it is likely that the Air Traffic Administrator would be able to manage the position until a successful transfer to a successor.
- 6.7 On this basis, we have concluded that:
- the analysis we have conducted and summarised in paragraph 6.6 indicates that the risk of disruption is relatively low, or at least manageable as part of any administration;

- arrangements under which all employees in a corporate group are employed by a single service company are common and do not appear to have posed any demonstrable difficulties in other regulated industries; and
- any change to the existing arrangements would be likely to take a significant amount of management and employee time (and create potential disruption) for little apparent benefit.

6.8 As a result, we do not consider that taking action at this time in this area is proportionate to any residual risk that may still be present. We do not, therefore, propose that any specific obligations should be imposed on NERL in relation to its employment arrangements, other than the general “sufficiency of resources” obligations discussed in Chapter 5.

Cross default obligations

- 6.9 We have also considered whether the ring-fence obligations should be amended so that the licence can operate in relation to NERL’s obligation not to create or allow to continue cross default obligations without the need for consents. At present, under Condition 5, NERL is prohibited from entering into cross default obligations without consent, unless those obligations, taken as a whole, do not cause a “material increase in risk” for NERL⁵. NERL currently benefits from consent letters in relation to its financing arrangements.
- 6.10 We have reviewed this provision in order to determine whether this obligation could be simplified to remove or replace the “secondary test” set out in paragraph 19 of Condition 5. As currently drawn, this requires NERL to assess whether the cross defaults create a material increase in risk for NERL, or whether that test could be replaced by another one that enabled the financing arrangements to continue without the need for consent.
- 6.11 Having reviewed this test, taken the views of NERL into account, and considered the practice of other regulators in relation to cross default obligations, we are not currently minded to change the existing obligations. Despite the fact that this change would give the CAA better sight of the arrangements which NERL is entering into, we believe that the advantages this would bring may be outweighed by the negative consequences of such a change. These are as follows:

⁵ See condition 5, paragraph 19 of NERL’s licence.

- while removing the “secondary test” would simplify the obligation on NERL, it would also make it more onerous, as NERL would need to consider either removing any cross default obligations from its activities, or gaining consent for all of them; alternatively
- the CAA might be called on to grant many more consents, or consents of a much wider scope, in order to allow NERL to carry on activities that do not raise significant issues or risks for the regulated business;
- in either case, the removal would lead to a significant increase in the need for both NERL and the CAA to devote resources to the analysis of arrangements of limited importance;
- the existing test places the onus of compliance firmly on NERL, which is the party best placed to assess the risks that it is taking on;
- the presence of a consent mechanism allows NERL to be able to take on greater cross default risks where appropriate, so suitable risk mitigations can be mandated by the CAA as part of the grant of the consent; and
- the present test appears to create a proportionate balance of risk between consumers and NERL.

6.12 While we do not propose to change this provision, we are mindful that NERL needs to have certainty in its activities and in relation to the CAA’s attitude to the risks that it is taking on. As a result, we wish to make it clear, that, while it is for NERL to comply with its licence, we will engage with it, in appropriate circumstances, to discuss whether consent is needed in a particular case. We would expect these discussions, provided NERL can provide us with sufficient detailed information to enable us to conduct our analysis satisfactorily, will enable us either to grant consent, or to confirm formally to NERL that no consent is required on the basis of the information in front of us. This approach should give NERL an appropriate level of the comfort to enable it to carry out its activities effectively and efficiently.

Extending the ring-fence

6.13 We also considered whether it would be appropriate to draw a ring-fence around either the whole of the NATS operating companies or its UK activities. The licence currently places restrictions on the activities of NERL only. In principle, this could be extended to restrict activities of all group entities party to the financial arrangements of NERL. In effect this

would bring them within the ring-fence. NATS could continue to pursue any business venture outside of this ring-fence without any involvement of the CAA. In effect this might mean all UK air traffic services activities, including staff, would be bought within the ring-fence and all non-UK or non-air traffic services activities falling outside the ring-fence.

- 6.14 This would have a number of implications. In particular, widening the ring-fence would have the effect of bringing the activities of NSL within the regulatory scheme of NERL's licence (albeit to a lesser extent than the En Route activities of NERL) and would bring with it a need to consider how the revenues of the various activities within the ring-fence were to be treated. Alternatively, it would lead to a consideration of whether those wider activities were inside or outside the ring-fence for particular purposes.
- 6.15 As a result, this approach does not appear to lend itself to the development of a set of regulatory rules that are either simple or easy to comply with, and would appear to extend the burden of regulation beyond that which is needed in order to address the issues at hand. As such, we have decided not to pursue this approach further.

Chapter 7

Cost of implementing the initial proposals

Governance proposals

- 7.1 It is clear that requiring NERL to have independent directors on its company board would impose an administrative and financial burden on it. While it is clearly the responsibility of each company to respond to obligations in respect of independent directors in the manner it sees fit, in NERL's case, the need to ensure that the NERL board transacts significant business in relation to NERL may be expected to drive up transparency in the operation of the board of NERL and ensure that it conducts its business separately from that of the wider NATS board meetings.
- 7.2 We are aware that other regulated utilities which have requirements to appoint independent directors on their boards take a variety of approaches to their governance structures and that, at least to some extent, these are driven by the other regulatory rules to which they are subject. For example, companies that are subject to onerous business separation obligations between regulated and unregulated businesses and regulated businesses that are required by their licences to comply with the UK Corporate Governance Code may take a different view as to the need for the licensee board to be supported by a dedicated committee structure than a company that does not. In any event, the Code does not create absolute obligations in relation to corporate governance, but rather creates requirements to "comply or explain" which, of itself gives companies flexibility as to how to organise their governance arrangements.
- 7.3 As a result, and since we are not proposing that NERL is itself subject to the UK Corporate Governance Code, we do not expect that a requirement to appoint independent directors to the board of NERL would necessarily lead to NERL being required to duplicate the whole of the governance and committee structure that it has at group level. By contrast, we would expect that NERL should be able to organise its governance and internal structures in such a manner that enabled the independent directors to operate effectively within the Board of NERL, but that it should have a good deal of flexibility in the manner in which it chooses to do this. As such, we do not consider that the presence of independent directors on the Board of NERL will interfere with the structure of the PPP.

- 7.4 That said, there will inevitably be direct and indirect financial costs associated with such appointments. From the evidence we have, these appear likely to be in the range of the low tens of thousands of pounds per annum per director.

Financial ring-fence proposals

- 7.5 We have received evidence from NATS about the means by which it seeks to ensure that it complies with the ring-fence and other licence obligations. Having reviewed this, we consider that it is relatively straightforward for NERL to use this material in order to support the additional certification and reporting that we are proposing. As such, the obligations we are proposing largely represent providing the CAA with assurance of the systems and processes that NERL already has in place.

Conclusion

- 7.6 The financial and administrative burden of these initial proposals would appear to be readily outweighed by the benefits to consumers outlined above and the general business benefits that come from having high quality independent directors on the board.
- 7.7 Furthermore, it would appear that the financial costs are not material in the context of the RP2 settlement or the size of the NERL business as a whole. We therefore consider that of the range of options we have considered, the package of proposals that we are putting forward appears to be the most effective and proportionate solution to the problems identified above and does not impose an unnecessary burden on NERL in delivering those benefits to consumers.
- 7.8 In conclusion, the CAA considers that the impact of these changes is not likely to be significant in terms of cost and resources for NERL, as they largely bolster existing obligations and/or require additional clarity on things that NERL would be carrying out to ensure compliance already.

Chapter 8

Summary and Next Steps

Summary

- 8.1 The CAA's Ad Hoc Review of NATS related risks identified that further work would be required to examine the options for strengthening NERL's financial resilience in the areas of governance and financial ring-fencing. The CAA's detailed work in this area has led to the assessment of a number of options to address these concerns.
- 8.2 On governance, the CAA's initial proposal is to require NERL to appoint two competent mandated independent directors to its Board, and ensure that at least two are required for quorum. The CAA considers that this new requirement would help to promote greater rigour in NERL's corporate governance and enhance the compliance culture.
- 8.3 On the financial ring-fence, the CAA currently favours a package of proposals including:
- re-focussing NERL's annual directors' resources certificates to give additional clarity to and emphasis on operational as well as financial resources;
 - new statements from the directors setting out the processes used and factors considered in issuing the resources certificates;
 - requiring new certificates from NERL's directors that the licensee has complied with certain ring-fence elements, such as not to enter into cross defaults nor give or receive cross-subsidies;
 - a new requirement to re-state the compliance certificates prior to the declaration of dividends; and
 - maintenance of an intervention plan to assist a special administrator in the event of insolvency.
- 8.4 Taken together, the CAA considers that the benefits of these proposals in terms of improved governance and transparency significantly exceed the cost to NERL in the form of a slightly higher regulatory burden and some small additional financial costs related to compliance. We, therefore, consider that the proposals set out above would be an effective and proportionate solution to the problems identified.

- 8.5 To provide an illustration of how these changes could be implemented in practice, the Appendices set out illustrative drafting for the potential modifications to NERL's licence conditions.

Next steps

- 8.6 We welcome views from stakeholders on all of the issues considered in this consultation document particularly the CAA's assessment of options set out in Chapters 4 to 6. The deadline for responding to this consultation is 8 June 2015.
- 8.7 Having considered any responses, we currently expect to issue statutory licence modification proposals during August 2015 with a view to modifying the licence formally in October 2015 such that the proposed changes will take effect from 2016.
- 8.8 Under Section 11(1) of the Act the CAA may modify the conditions of a licence if its holder consents to the modifications. Should NERL choose to withhold its consent to the changes, the CAA will have the option under Section 12(1) of the Act of referring the matter to the Competition and Markets Authority to investigate and report upon whether the matter operates against the public interest.

APPENDIX A

Illustrative proposed modification to Licence Condition 5: Availability of Resources and Financial Ring-Fencing

This appendix provides an illustration of the amendments that would be made to Condition 5: Availability of Resources and Financial Ring-Fencing of NERL's licence to implement the proposed additional certification obligations. The new drafting highlights the changes against the existing text of those conditions.

The following existing sub-conditions in Condition 5 would be retained without amendment:

- Restriction on Activity and Financial Ring-Fencing
- Amendments to the Finance Documents
- Disposal of Relevant Assets and Indebtedness
- Ultimate Holding Company Undertaking
- Credit rating of Licensee
- Financial Indebtedness

PART II THE GENERAL CONDITIONS

Condition 5: Availability of Resources and Financial Ring-Fencing

1. The objectives of this Condition are to set out measures which, inter alia:-
 - (a) require the Licensee to act in a manner calculated to secure that it has available to it sufficient resources to perform its Licence obligations and that it informs the CAA about the resources available to it and its compliance with certain conditions of this licence;
 - (b) limit the scope of activities which the Licensee undertakes which are outside the En route (UK) Business and the En route (Oceanic) Business;
 - (c) create an effective financial ring-fence around the En route (UK) Business and the En route (Oceanic) Business and promote transparency;
 - (d) require the Licensee to make the CAA aware of any material steps proposed to be taken under the Finance Documents;
 - (e) require the Licensee to notify the CAA on the occurrence of certain events which might prejudice the licensees' financial stability;
 - (f) control the disposal of relevant assets, and place certain restrictions on the ability of the Licensee to incur debt;
 - (g) require the ultimate holding company to undertake not to act, or cause any subsidiary to act, in such a way as to cause the Licensee to breach the Licence;
 - (h) prohibit the Licensee from entering into any agreement or arrangement with any affiliate or related undertaking except on an arm's length basis and on normal commercial terms unless otherwise permitted;
 - (i) require the Licensee to use all reasonable endeavours to maintain at all times an investment grade issuer credit rating; and
 - (j) establish a financial gearing target and cap.

This paragraph 1 provides a descriptive summary of the provisions which follow in this Condition. This paragraph 1 is not intended to add to the provisions which follow, and for the purposes of interpretation it is the detailed provisions which prevail.

Availability of Resources

2. The Licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial, management and staff resources, fixed and moveable assets, rights, licences, consents and facilities, on such terms and with all such rights as shall ensure that it is at all times ~~to enable~~ it to:
- (a) carry out its Permitted Purpose activities; and
- (b) comply in all respects with its obligations under the Act and this Licence including, without limitation, its duties under section 8 of the Act.

Certificates for the CAA in relation to financial resources

3. With effect from 1 January 2016, ~~t~~The Licensee shall submit a certificate addressed to the CAA, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee appointed under Condition 8 (—Requirement for mandated independent directors) pursuant to that resolution. Such certificate shall be submitted ~~—~~within four months of the end of the Licensee's financial year. Each certificate shall be in one of the following forms:
- (a) "After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the Licensee, any amounts of principal and interest due under any loan facilities and any actual or contingent risks which could reasonably be material to their consideration, sufficient financial resources and other resources and financial and operational facilities available to itself to enable the Licensee to carry on the Permitted Purpose activities and comply with its obligations under the Act and under this its Licence to which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject (as amended from time to time) for a period of two years from the date of this certificate."
- (b) "After making enquiries based on systems and processes established by the Licensee appropriate to the purpose, the directors of the Licensee have a reasonable expectation, subject to what is said below, that the Licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the Licensee, any amounts of principal and interest due under any loan facilities, and any actual or

contingent risks which could reasonably be material to their consideration, sufficient financial ~~and other~~ resources and financial ~~and operational~~ facilities available to itself to enable the Licensee carry on the Permitted Purpose activities and to comply with its obligations under the Act and under this its Licence to which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject (as amended from time to time) for a period of two years from the date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the Licensee to comply with its obligations under the Act and under such Licence for that period.....”

- (c) “In the opinion of the directors of the Licensee, the Licensee will not have available to it sufficient financial ~~or other~~ resources and financial ~~and operational~~ facilities available to itself to enable the Licensee carry on the Permitted Purpose activities and to comply with its obligations under the Act and under this its Licence to which the Licensee is aware or could reasonably be expected to make itself aware it is or will be subject (as amended from time to time) for a period of two years from the date of this certificate.”

4. ~~[Paragraph deleted]~~ The Licensee must ensure that the certificate given to the CAA under paragraph 3 is accompanied by a statement of the main factors that the Licensee’s directors have taken into account in giving that certificate including reference to:

(a) the systems and processes established by the Licensee to support the giving of the certificate by the directors;

(b) the main financial resources and financial facilities available to the Licensee; and

(c) the most recent cash flow statement prepared for the Licensee together with a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee.

~~5. The Licensee shall inform the CAA in writing as soon as practicable if the directors of the Licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under paragraph 3(a) or 3(b).~~

Certificates for the CAA in relation to operational resources

~~6. The Licensee shall obtain and submit to the CAA with each certificate provided for in paragraph 3 a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee~~

5. With effect from 1 January 2016, the Licensee must within four months of the end of the Licensee's financial year give the CAA a certificate that has been approved by a resolution of the Licensee's board of directors and signed by a director of the Licensee appointed under Condition 8 (Requirement for mandated independent directors) pursuant to that resolution and is in one of the following forms:

(a) Certificate 1R

"After making enquiries, the Licensee's directors have a reasonable expectation that the Licensee will have sufficient operational resources including management, personnel, fixed and moveable assets, rights, licences, consents, and facilities available to itself to enable the Licensee to carry on the Permitted Purpose activities and to comply with its obligations under the Act and under this Licence (as amended from time to time) for a period of two years from the date of this certificate."

or

(b) Certificate 2R

"After making enquiries, the Licensee's directors have a reasonable expectation, subject to what is explained below, that the Licensee will have sufficient operational resources including management, personnel, fixed and moveable assets, rights, licences, consents, and facilities available to itself to enable the Licensee to carry on the Permitted Purpose activities and to comply with its obligations under the Act and under this Licence (as amended from time to time) for a period of two years from the date of this certificate.

However, the directors of the licensee would like to draw attention to the following factors, which may cast doubt on the licensee's ability to carry on the Permitted Purpose activities [followed by a description of the factors concerned]."

or

(c) Certificate 3R

"In the opinion of the Licensee's directors, the Licensee will not have sufficient operational resources including management, personnel, fixed and moveable assets, rights, licences, consents, and facilities available to itself to enable the Licensee to carry on the Permitted Purpose activities and to comply with its obligations under the Act and under this Licence (as amended from time to time) for a period of two years from the date of this certificate."

6. [Paragraph deleted]The Licensee must ensure that the certificate given to the CAA under paragraph 5 is accompanied by a statement of the systems and processes established by the Licensee to support the giving of the certificate by the directors and the main factors that the Licensee's directors have taken into account in giving that certificate.

Certificate for the CAA in relation to compliance with certain Conditions

7. With effect from 1 January 2016, the Licensee must, within four months of the end of the Licensee's financial year, give the CAA a certificate that has been approved by a resolution of the Licensee's board of directors and signed by a director of the Licensee appointed under Condition 8 (Requirement for mandated independent directors) pursuant to that resolution and is in one of the following forms:

(a) Certificate 1C

"After making enquiries the Licensee's directors consider that, at the time of their approval of this certificate, the Licensee is in compliance in all material respects with all of the obligations imposed on it by Condition 17 (Provision of information to the CAA for regulatory purposes), Condition 5 (Availability of resources and Financial Ring Fencing) and Condition 9 (Prohibition of cross-subsidies)."

or

(b) Certificate 2C

"In the opinion of the Licensee's directors, the Licensee is not at the time of their approval of this certificate in compliance in all material respects with all of the obligations imposed on it by Condition 17 (Provision of information to the CAA for regulatory purposes), Condition 5 (Availability of resources and Financial Ring Fencing) and Condition 9 (Prohibition of cross-subsidies) [followed by a description of the way in which the Licensee is not complying]."

8. The Licensee must inform the CAA in writing immediately if:

- (a) the directors of the Licensee become aware of any circumstance that causes them no longer to have the reasonable expectations expressed in the most recent certificate given under paragraph 3(a), 3(b), 5(a) or 5(b); or
- (b) the directors of the Licensee consider that any adverse circumstances that caused them to give the CAA a certificate in the form of under paragraph 3(b), 3(c), 5(b) or 5(c) have materially worsened.

Certificates for the CAA in relation to dividends

- 8A. Subject to paragraph 8D, the directors of the Licensee must not declare or recommend a dividend, and the Licensee must not make any other form of distribution within the meaning of sections 829, 830, 849 and 850 of the Companies Act 2006, or redeem or repurchase any share capital of the Licensee, unless before declaring, recommending, or making the distribution, redemption, or repurchase (as the case may be) the

Licensee has given the CAA a certificate that complies in all respects with the three requirements set out in paragraphs 8B and 8C below.

8B The first requirement is that the certificate must be in the following form:

“After making enquiries, the directors of the Licensee are satisfied:

(a) that, at the time of their approval of this certificate, the Licensee is in compliance in all material respects with all of the obligations imposed on it by Condition 17 (Provision of information to the CAA for regulatory purposes), Condition 5 (Availability of resources and Financial Ring Fencing) and Condition 9 (Prohibition of cross-subsidies);

and

(b) that the making of a distribution, redemption, or repurchase of [value] on [date] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the Licensee to be in breach to a material extent of any of those obligations in the future.”

8C. The second and third requirements are that the certificate:

(a) must have been approved by a resolution of the Licensee’s board of directors passed not more than 14 days before the date on which the declaration, recommendation, or payment is to be made; and

(b) must be signed by a director of the Licensee appointed under Condition 8 (Requirement for mandated independent directors).

8D. The Licensee need not give the CAA a certificate of the type referred to in paragraph 8B in circumstances where:

(a) during the six months preceding the declaration or recommendation of a dividend, the making of any other form of distribution or the redemption or repurchase of share capital, it has given the CAA a certificate in the form of Certificate 1C under the requirement set out in paragraph 7 of this Condition; and

(b) that certificate includes an appropriate addendum using the wording given at paragraph 8B(b) of this Condition.

8E. Where the certificate given under paragraph 8A, or relied upon under paragraph 8D, relates to the declaration or recommendation of a dividend, the Licensee is under no obligation to issue a further certificate before paying that dividend so long as such payment is made within six months of the date on which the certificate was given.

APPENDIX B

Illustrative proposed additional Licence Condition 7: Requirement to Maintain an Intervention Plan

This appendix provides an illustration of a proposed new condition on the requirement to maintain an intervention plan.

Condition 7: Requirement to maintain an intervention plan [Currently “[NOT USED]”]

1. The Licensee must prepare by 1 April 2016, or within 6 months of this condition coming into effect in this licence, whichever is the later and, thereafter, maintain an intervention plan fulfilling the criteria set out in paragraph 3 below.
2. The requirement for the information described in paragraphs 3 below will be satisfied if the plan provides details of other documents or records (including electronic records) where that information can readily be obtained and those documents or records are either maintained by the Licensee itself or are available to the licensee at all times under a legal or contractual right.
3. For the purposes of this condition, an intervention plan shall be a document or set of documents (which may be in a suitably secure electronic format) containing information that would be sufficient to allow any person appointed under an air traffic administration order (within the meaning in Chapter I of the Act) in respect of the Licensee readily to obtain the information they could reasonably be expected to require in order for that person efficiently to carry out his functions and to remain compliant with the Act and this licence. The form of the intervention plan shall, as a minimum, contain information on:
 - (a) the financial assets, resources and facilities of the Licensee;
 - (b) the non-financial assets, rights and resources of the Licensee, including information on key management and operational personnel and information technology systems;
 - (c) the liabilities of the Licensee, including contingent and contractual liabilities with counterparty and maturity information;
 - (d) the tax affairs of the Licensee;
 - (e) the personnel of the Licensee and any personnel employed by any affiliate or related undertaking of the Licensee who are engaged in operating any aspect of the Permitted Purpose activities of the Licensee;

- (f) any pension schemes of which those personnel referred to in subparagraph (e) above are members and which are sponsored or administered by the Licensee or any affiliate or related company of the Licensee;
 - (g) any mortgages, charges, or other forms of security over the Licensee's assets; the systems and processes by which the Licensee carries on the En route Businesses with information on any significant contractual arrangements, including those that impose obligations on the Licensee;
 - (h) any arrangements under which the Licensee has delegated any part of the En route Businesses to any affiliate of the Licensee;
 - (i) any contractual rights to receive cash or other financial assets from any affiliate of the Licensee or any other person;
 - (j) any contractual obligations to deliver cash or other financial assets to any affiliate of the Licensee; and
 - (k) the Licensee's arrangements and procedures for ensuring compliance with legislative requirements and with its obligations under this licence, including the conditions set out in Part III of this licence.
4. The form scope and detail of the intervention plan prepared in accordance with paragraph 1 of this condition shall be approved by the CAA (such approval not to be unreasonably withheld or delayed).
5. The Licensee keep the intervention plan under review at all times and, at least annually, shall review the appropriateness of the intervention plan and submit to the CAA a certificate, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee appointed under Condition 8 (Requirement for mandated independent directors) pursuant to that resolution by within four months of the end of the Licensee's financial year. Such certificate shall be in the following form:

"The Licensee has reviewed its intervention plan as required by condition 7 of its licence. In the opinion of the directors of the Licensee, the intervention plan is fit for purpose and complies with the Licensee's obligations under that condition."

APPENDIX C

Illustrative proposed additional Licence Condition 8: Requirement for mandated independent directors and corporate governance

This appendix provides an illustration of a proposed additional condition on the requirement for mandated independent directors and corporate governance.

Condition 8: Requirement for mandated independent directors and corporate governance [Currently “[NOT USED]”]

1. Where potential conflicts exist between the interests of the Licensee and those of any affiliates or related undertakings of the Licensee, the directors of the Licensee, in discharging their responsibilities as directors of the Licensee must act independently of the interests of any affiliate or related undertaking of the Licensee and ensure that they have regard exclusively to the interests of the Licensee.
2. Subject to paragraph 11, the Licensee must ensure that at all times after a date which is 12 months after this condition comes into effect, it has at least two non-executive directors who meet the criteria set out in paragraphs 3, 4 and 5 below. In this condition such directors are referred to as “mandated independent directors”.
3. A mandated independent director must:
 - (a) be a natural person;
 - (b) in the reasonable opinion of the Licensee, have the skills, knowledge, experience, and personal qualities necessary to perform effectively as a non-executive director of the Licensee and participate fully in the decision making of the board of directors of the Licensee;
 - (c) not have any executive duties within the Licensee’s business; and
 - (d) be of sufficient standing to ensure that directors of the Licensee, in discharging their responsibilities as directors of the Licensee, act independently of the interests of any affiliate or related undertaking of the Licensee and ensure that they have regard exclusively to the interests of the Licensee.
4. A mandated independent director must not be, and must not have been during the 12 months before his appointment as a director of the Licensee or the coming into force of this condition (whichever is the later):
 - (a) an employee of the Licensee; or
 - (b) a director or employee of an associate of the Licensee.
5. A mandated independent director must not:

- (a) have, or have had during the 12 months before his appointment as a director or the coming into force of this condition (whichever is the later), any material business relationship with the Licensee or any associate of the Licensee;
 - (b) hold a remit to represent the interests of any particular shareholder or group of shareholders of the Licensee or the interests of any associate or the interests of any particular shareholder or group of shareholders of any associate of the Licensee; or
 - (c) receive remuneration from the Licensee or any associate of the Licensee apart from a director's fee and reasonable expenses.
- 6. For the purposes of sub-paragraphs 5(a) and 5(c) respectively:
 - (a) the holding of a small number of shares or associated rights in the Licensee or any associate of the Licensee shall not, of itself, be considered a material business relationship; and
 - (b) the receipt or retention of any benefit accrued as a result of prior employment by or service with the Licensee or any associate of the Licensee shall not be considered to be remuneration.
- 7. The Licensee must notify the CAA of the names of its mandated independent directors within 14 days of the later of the two dates referred to in paragraph 1 and must notify the CAA within 14 days where any new directors are appointed to fulfil the obligation in paragraph 2 of this condition.
- 8. The terms of appointment of each mandated independent director must include a condition stipulating that both the Licensee and the appointee will use their best endeavours to ensure that the appointee remains independent during his term of office, having particular regard to the criteria set out in paragraphs 3, 4 and 5.
- 9. A term of appointment for a mandated independent director may not be for longer than eight years, but an individual may be reappointed thereafter provided that he continues to meet the criteria set out in paragraphs 3, 4 and 5.
- 10. The Licensee must notify the CAA in writing within 14 days if any mandated independent director is removed from office or resigns, giving reasons for the removal or (to the extent that they are known to the Licensee) the resignation. For the purposes of this requirement, the reasons for a resignation may, if applicable, be stated to be personal reasons.
- 11. If at any time the Licensee has fewer than two mandated independent directors because of a removal or resignation or other reason (including death or incapacity), the Licensee must use reasonable endeavours to ensure that a new director is, or new directors are, appointed to fulfil the obligation in paragraph 2 as soon as is reasonably practicable to bring the number of mandated independent directors up to at least two.
- 12. Where mandated independent directors have been appointed to fulfil the obligation in paragraph 2 this condition, the Licensee must ensure that

meetings of its board of directors are not quorate unless attended by at least two of those mandated independent directors.

Interpretation

13. In this condition:

“associate” means:

- (a) an affiliate or related undertaking of the Licensee;
- (b) an ultimate holding company of the Licensee;
- (c) a participating owner of the Licensee; or
- (d) a common control company;

“common control company” means any company, any of whose ultimate holding companies (applying the definition set out in Condition 1 (Interpretation and construction) but substituting that company for the Licensee) is also an ultimate holding company of the licensee;

“participating owner” - For the purposes of the definition of associate above, a person is subject to a participating interest by another person (a “participating owner”) if:

- (a) that other person holds a participating interest in the person; or
- (b) the person is subject to a participating interest by a person who is himself subject to a participating interest by that other person; and

“participating interest” has the meaning given in section 421A of the Financial Services and Markets Act 2000.

APPENDIX D

Illustrative modification of Licence Condition 9: Prohibition of cross-subsidies

This appendix provides an illustration of a modification to Condition 9: Prohibition of cross-subsidies.

Condition 9: Prohibition of cross-subsidies

1. The Licensee shall procure that no Separate Business or part of a Separate Business gives any cross-subsidy (whether in money or money's worth) to, or receives any cross-subsidy from, any other business or part of any other business of the Licensee or any affiliate or related undertaking of the Licensee (whether or not a Separate Business) ~~where such cross-subsidy has or is intended to have or is likely to have the effect of preventing, restricting or distorting competition in any market for the provision of air traffic services.~~
2. Where the CAA is satisfied the Licensee is giving or receiving, or has given or received, any cross-subsidy prohibited by paragraph 1 the Licensee shall take such steps, set out in directions issued by the CAA, as are necessary to ensure that it complies with paragraph 1.