

# The CAA's approach to the regulation of terminal air navigation service for RP2

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## CHAPTER 1

# Introduction

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- 1.1 This document sets out the CAA's approach to the regulation of terminal air navigation services (TANS). The CAA set out its proposed approach in '*Approach to terminal air navigation service regulation in RP2 - a consultation*' (CAP 1132)<sup>1</sup> which the CAA published in December 2013. The consultation formally closed on 8 January 2014.
- 1.2 The CAP 1132 consultation dealt with regulatory issues however inevitably there were some aspects of competition raised in the NSL business plan as well as in the responses. For clarity the discussion in this document relates purely to the application of the RP2 regulation to TANS. It does not discuss or deal with the potential issues raised in CAP 1004 other than as background to the CAA's approach. The CAA is still considering its position with regards to the competition implications of the CAP 1004 finding which forms an area of work distinct from that of the RP2 regulations. Where appropriate responses to CAP 1132 will be considered within CAA's work in that area.
- 1.3 The RP2 regulations for TANS applies to towers contained within 'charging zone B' those with over 70,000 IFR movements on average for the last three years. For the RP2 period the towers that will be covered by regulation are as follows:
- Heathrow Airport;
  - Gatwick Airport;
  - Manchester Airport;
  - Stansted Airport;
  - Edinburgh Airport;
  - Luton Airport;
  - Birmingham Airport;

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<sup>1</sup> This can be viewed on the CAA website at: [www.caa.co.uk/cap1132](http://www.caa.co.uk/cap1132)

- Glasgow Airport; and
- London City Airport.<sup>2</sup>

1.4 The document is set out as follows:

- Chapter 2: Summary of Responses;
- Chapter 3: CAA's approach to TANS; and
- Chapter 4: Enforcement.

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<sup>2</sup> The CAA has become aware on the latest available data that London City Airport would come within scope of the regulation. The Draft NSL business plan did not cover London City.

## CHAPTER 2

# Responses to consultation CAP 1132

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- 2.1 The CAA's initial consideration on its approach was set out in CAP 1132. This chapter summarises the responses received to that consultation.
- 2.2 The CAA received seven responses to CAP 1132 on the approach to regulating TANS in RP2. The responses were from:<sup>3</sup>
- NATS Services Ltd (NSL);
  - Heathrow Airport Limited (HAL);
  - Manchester Airport Group (MAG);
  - British Airways (BA);
  - International Air Transport Association (IATA);
  - a joint response from Prospect and PCS (Prospect/PCS); and
  - the Guild of Air Traffic Controllers (GATCO).
- 2.3 Respondents commented on NSL's draft RP2 Business Plan and Capita's benchmarking study as well as upon our proposed approach to regulation.
- 2.4 The remainder of this chapter sets out the responses under the main themes.
- Section 1: Form of regulation;
  - Section 2: Transparency of data;
  - Section 3: Performance targets;
  - Section 4: NSL's draft commitments; and
  - Section 5: General comments.

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<sup>3</sup> The full responses are on our website at <http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=585>

## Section 1: Form of regulation

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- 2.5 Respondents presented different views on how contestable the market is and consequently what form of regulation would be appropriate:
- NSL thought the TANS market was contestable now, as shown by the recent public procurement exercises at Birmingham and Luton, as well as the on-going one at Gatwick. It looked to work with the CAA on its proposed commitments to enhance market conditions.
  - Prospect/PCS thought that the TANS market was for all intents and purposes a contestable market.
  - IATA did not believe there was genuine contestability at the larger airports. It thought that more robust economic regulation was required and that a single charging zone was inconsistent with a contestable market and airline requirements for more cost related and site specific charging systems. It did not regard the use of a return of sales instead of the cost of capital as supporting the regulatory role of replicating a competitive market;
  - MAG wanted the CAA to continue to work to encourage the development of a contestable TANS market which it saw as the most sustainable way in the long term to ensure airports' needs are met.
  - HAL said it would need a minimum of two, ideally three, credible alternatives to NSL to run a full competitive tender process which it did not expect in the medium term, and certainly not in the next 12-24 months when it expected to begin its tender process.

## Section 2: Transparency of data

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- 2.6 A number of respondents were concerned about a lack of transparency, in terms of both redactions from the Capita benchmarking report and ongoing reporting of ANSP cost data in RP2:
- BA, IATA, MAG and GATCO thought the published version of the benchmarking report was so heavily redacted to be meaningless. BA said without the provision of cost data at an airport level it would be unable to fully support any targets set at a system level. MAG

thought the CAA should establish an appropriate way for airports and other stakeholders to comment on the benchmarking study in due course.

- IATA said that publishing cost-efficiency data at an airport level would increase pressure for efficiency gains and provide the transparency required by users.
- HAL thought it would require a level of cost transparency to enable it to determine a value for money contract. At the very minimum ANSPs should be required to share information on return on sales with individual airports. However, it thought the publication of contract prices and costs more widely could deter market entry, innovation and cost efficiencies.
- IATA thought there should be transparency on the key performance indicators and service level agreements between airports and their ANSPs;
- MAG agreed that the publication of data should be limited to the aggregate charging zone level to maintain commercial confidentiality.
- Prospect/PCS thought that too much information could result in inappropriate contracts being awarded which might not be compatible with the provision of a safety critical service.

### Section 3: Performance targets

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2.7 Respondents had mixed views on NSL's cost efficiency target of RPI-2% for RP2:

- BA, IATA and HAL thought it was insufficiently challenging, as it only foresaw cost savings through increased volumes. BA compared it unfavourably to NERL's cost efficiency proposals for RP2. HAL compared it unfavourably to the CAA's regulation of Heathrow.
- MAG thought there was considerable scope for cost reductions to be delivered in a relatively short space of time, as an unregulated business in a non-contestable market was likely to have accumulated significant inefficiencies and failed to keep pace with market norms.

- Prospect/PCS generally agreed with NSL's approach to achieving better value for money through an increase in traffic. The exception being Heathrow which it saw as a specialist operation at which improvement was constrained. Prospect/PCS also said the target should allow for an increase in contract price if additional services are taken on within the contract or that the market dictates that the price of service provision increases. They thought that with more providers seeking to provide a service from a relatively limited talent pool staff mobility could increase leading to providers needing to improve enhanced terms in order to retain staff. They did not think that cost reduction should necessarily be assumed and cost savings should not be secured through a reduction in their members' terms and conditions.
- GATCO said that cost and capacity targets should be considered together, as pushing more aircraft through airspace would drive down the unit price.

2.8 Respondents also had mixed views on NSL's capacity target of 0.05 for delay attributable to NSL (for staffing and technical issues) for RP2:

- BA and IATA thought NSL's RP2 delay forecasts did not demonstrate sufficient ambition, as although performance was forecast to be broadly the same as the 2008-12 average, it would be a significant deterioration against the forecast outcome for 2013. In particular, BA regarded the forecast RP2 outcome for Heathrow of 0.74 minutes of delay/flight as unacceptable. HAL thought it unclear whether NSL's delay forecasts for Heathrow at the end of RP2 would occur after investment by HAL and NATS to change the ATM system and associated procedures to improve adherence to schedule.
- GATCO mentioned that in setting environmental and capacity targets consideration should be given to delays caused by airport and airspace structural issues.
- Prospect/PCS thought that ANSPs should only be responsible for capacity delays due to equipment or staff provision for which they are directly responsible. They considered that there was a limit to how much capacity could be increased without infrastructure upgrades.

## Section 4: NSL's commitments

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2.9 MAG thought that the relationship between NERL and NSL was the key issue, but the draft commitment to address the lack of clarity around the relationship between NERL and tower operations was not robust or detailed enough at present. It considered that more detail was required on the key elements of an interface agreement and that the proposed parties to the agreement should be identified.

## Section 5: Other comments

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2.10 Other comments included:

- MAG was concerned that NSL's draft Business Plan lacked detail on how services provided by NSL added value to airports. MAG would like to see NSL commit to working more closely with airports with critical success measures identified to evaluate how this could be achieved. It was also concerned that NSL had not always sought to add value to airports by providing customised services. For example on occasion NSL had been reluctant to provide bespoke data to Stansted.
- HAL welcomed NSL's Business Plan and agreed with its priorities. However, it thought the Plan did not adequately address the full scope of SESAR deployment, nor how NSL would contribute to FAS.
- GATCO welcomed many aspects of NSL's vision of the future through optimisation of airspace leading to continual vertical trajectories and enhanced queue management, but was concerned around the insistence that increased automation would reduce the need for operational staff while increasing capacity and safety.
- GATCO thought the form of system integration in NSL's plan could contradict the current concept of the decentralisation of services favoured by the European Commission.
- Prospect/PCS said while it accepted that technological improvements were inevitable full engagement with the workforce and representatives would be necessary in order to realise any benefits in terms of enhanced productivity.

- Prospect/PCS said that the difference in operational techniques at different airports did not necessarily lend itself to a 'one size fits all' systemisation approach.
- IATA said that airlines should be consulted on corrective action where targets are not met.
- BA wanted to understand how the CAA will determine the accountability for delivery, or failure, of the targets.

**CHAPTER 3****CAA's approach for TANS**

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- 3.1 This chapter sets out the CAA's approach to the regulation of TANS. The CAA has sought to amend or provided further explanation around its approach to reflect concerns raised as part of the consultation process.
- 3.2 As previously stated the regulation is designed for a setting where direct charging between the TANS operator and the airline is the normal method funding for the TANS service. In the UK, however, direct charging is no longer undertaken.<sup>4</sup> TANS is a service provided by the airport either through self supply or outsourced to a third party.
- 3.3 As outlined in CAP 1004 the CAA has raised some concerns that it has with the level of contestability within the provision of TANS in the UK. The CAA has committed to undertake a programme of work to assess what steps it can take to improve contestability in the provision of these services. The CAA is aware that any interference has to be carefully judged so as not to hinder the development of contestability. To avoid hindering the development of contestability, the CAA intends to apply the Scheme in a proportionate manner. In particular the CAA aims:
- not to cut across the provisions in current contracts; and
  - to ensure that airports are able to operate a fair and open tender process.
- 3.4 To achieve this result the CAA has had to take a number of steps around the provision of information and its approach to the cost of capital line. However the CAA will keep this approach under review and amend as necessary to reflect its view on contestability in the provision of TANS.
- 3.5 The chapter is set out as follows:

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<sup>4</sup> The London Approach service is provided centrally by NERL and is financed via direct charging. This service is not discussed within this chapter. The treatment of the London approach service is set out in CAP 1158.

- Section 1: Contracting for performance;
- Section 2: Approach to the cost efficiency KPI; and
- Section 3: Provision of information.

## Section 1: Contracting for performance

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- 3.6 Safety, the environment, capacity and cost efficiency are all aspects which an airport should take into account when awarding contracts and, where appropriate, performance on them should be incentivised within the contract.
- 3.7 The CAA considers that airports should have in mind the performance targets when seeking to award a contract. However, the CAA is aware that the exact transposition of the European KPIs and PIs into a contract may not be practicable as they are designed for regulation in the absence of market conditions. Airports should be in a position to negotiate on all issues relating to ANSP performance as part of their contract negotiations. The pressure of this regulation as well as the CAA's efforts to open up the market should provide impetus to the airport community.
- 3.8 The CAA maintains that airport operators are best placed to decide the areas and levels of performance needed to deliver the service they require for their customers. We expect as best practice that performance measures will form part of any contract negotiation. However we recognise that these may vary from airport to airport as airports seek to tailor their service to their customer base.
- 3.9 The CAA will set out its view on appropriate KPI targets within the draft national performance plan.

## Section 2: Approach to the cost efficiency KPI

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- 3.10 Article 4(3)<sup>5</sup> of the charging regulation sets out the ways in which TANS may be financed under the charging scheme. The article makes provision for TANS to be funded by other revenues rather than through the direct charging of airlines by the ANSP.

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<sup>5</sup> Article 4(3) says 'The determined costs of terminal air navigation services shall be financed by terminal charges imposed on users of air navigation services, in accordance with the provision of Chapter III, and/or other revenues'

- 3.11 Article 2 (10) defines other revenues to include a range of potential funding mechanisms including *"revenues obtained from contracts or agreements between air navigation service providers and airport operators"*. This is the funding model operated in the UK.
- 3.12 Article 12 of the charging regulation sets out the calculation of terminal charges that would be applicable if the TANS were funded through the direct charging of airlines. The CAA considers that as UK TANS revenues come from commercial the UK is exempt from the requirements of Article 12.
- 3.13 The regulation of UK TANS however does require the calculation of costs<sup>6</sup> and the provision of information by the ANSP for the purposes of target setting and monitoring of targets.
- 3.14 Given that the cost-efficiency KPI is set at the charging zone level the CAA intends to establish a charging zone level target with the expectation that contracting for TANS will provide the mechanism for its achievement.

### Cost of capital

- 3.15 As set out in Chapter 2 a number of respondents raised concern with the CAA's approach to the cost of capital for TANS. The CAA recognises those concerns. However the CAA maintains that adopting the approach the set by the regulation at this stage would not aid contestability within the market and would place a significant additional burden on industry. The CAA therefore provides additional explanation of its position below.
- 3.16 TANS provision in the UK is more of a service based operation than a capital focused business model. Although not consistent across all UK airports the TANS assets at airports that outsource service provision are often owned by the airport or by third party leasing companies. In some cases these assets and properties are leased to the TANS provider which includes these lease costs in the charges it makes to the airport.
- 3.17 The CAA considers that airport or third party ownership of operational assets is as an important enabler to the development of contestability, as it removes the need to transfer assets from the incumbent to the

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<sup>6</sup> Article 7.

any incoming provider.

- 3.18 The CAA has a number of concerns with applying the approach set out in article 7. These include:
- There is a potential risk of double counting of assets and rewarding both the airport and the ANSP for infrastructure provision. Where an airport owns the assets the return on this asset will likely already be factored into its airport charges either in its general approach to pricing or if regulated through a regulatory settlement. Developing and agreeing a suitable asset and cost allocation method would take time and add significant complexity and burden on industry for little to no gain in clarity over the cost of service provision.
  - Calculating a WACC for NSL (as the majority provider) would result in a lower WACC than may be consummate the risk of individual tower operations, as for NSL risk can be hedged across a portfolio of airports, including those not covered by the regulation. The need to calculate a separate WACC for each tower would introduce additional cost, complexity and burden on industry. The use of a lower NSL WACC would further embed the status quo, and be detrimental to the development of contestability.
  - Setting a WACC across the airports with cost-reflective pricing may necessitate significant changes in price (both increases and falls) at differing airports in the short term which would either cut across the current contracts or require significant changes in price when contract are renegotiated.
  - As noted above applying a WACC may incentivise ANSPs to own TANS assets, where to promote competition the CAA is encouraging the market to move to airport asset ownership.
  - Given airport ownership of assets rental charges associated with their use by ANSPs may be included within the contract as an operational cost.
- 3.19 In its initial data submission for RP2 in June 2013 NSL, in agreement with the CAA and DfT, did not present a WACC but, for reporting purposes, presented the profit it earns as a pre-tax return on sales on its contracts.
- 3.20 The CAA maintains that this is an appropriate approach given the

stage of market development and the ambition of the CAA to motivate a more competitive market place. Targeting cost reduction on the total cost charged by the ANSP to the airport will incentivise the reduction of margin and physical cost base as appropriate. However the CAA will need to review this approach in the lead up to RP3 to ensure that it is still appropriate.

### Section 3: Provision of information

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- 3.21 As set out in Chapter 2 a number of respondents have concerns with the level of information provision in both the NSL business plan and the CAA's benchmarking study.
- 3.22 As set out in Article 9 of the charging regulation there is a required level of cost transparency. Table 1 in Annex 2 of the charging regulation will need to be completed. This table must be completed in aggregate at the charging zone level, but also at each airport with over 70,000 IFR movements.
- 3.23 The CAA is aware that while data submissions to the Commission in June 2013 have been made at an airport level, for reasons of commercial confidentiality only aggregate data for the eight airports has been made publicly available. The CAA is hopeful that airports should gain cost transparency on TANS provision through running an open and competitive tender process.
- 3.24 While the CAA considers that some degree of cost transparency would assist in the development of market conditions for TANS provision. The CAA continues to consider that transparency at the individual airport level could be counter-productive as it could reveal too much information to potential bidders for TANS contracts and could lead to detrimental effects, such as:
- the maintenance of excess margins where the full contract price is known to potential bidders as it might reduce the incentive to compete vigorously. Bidders might only need to offer a contract at just less than the current contract price in order to win the contract. Where this is a more efficient supplier potential savings in the cost of the service would not be passed on to the airport or airspace users. Where the supplier is less efficient than the incumbent this may embed inefficiency in the market and reduce the scope for innovation as the operating margin is squeezed.

- 3.25 In general, European and domestic competition law considers the publication of contract prices and cost data as anti-competitive and not conducive to the development of contestability.
- 3.26 The CAA intends, therefore, that the publication of data should be limited to the charging zone level. Under current arrangements the ANSPs will supply the CAA with data for individual tower operations which the CAA shall handle in a way that it maintains commercial confidentiality. The CAA will not seek to share this with the individual airports but it encourages ANSPs to share cost data, as appropriate, with their airport customers as part of their commercial contract negotiations.

## CHAPTER 4

# Enforcement

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- 4.1 CAP 1132 outlined the CAA initial considerations on enforcement of the regulation. A number of stakeholders have requested additional information on how the CAA plans to enforce against these targets. This section sets out more formally the CAA's stance on enforcement.
- 4.2 Article 1(2) of EC 390/2013 states the following:
- "For the purposes of target setting and performance monitoring, this Regulation shall apply to the air navigation services provided by:*
- (a) the air traffic service providers designated in accordance with Article 8 of Regulation (EC) No 550/2004*
- ..."*
- 4.3 The CAA notes similarly that Article 1(2) of EC 391/2013 states:
- This Regulation shall apply to air navigation services provided by air traffic service providers designated in accordance with Article 8 of Regulation (EC) No 550/2004..."*
- 4.4 It is the CAA's intention that the regulatory package proposed will be applied via a modification of the ANSPs designation.
- 4.5 The annual reporting of performance in relation to the targets is set out under Article 18 of the performance regulation. The CAA will report performance to the Commission by 1 June in each year of the reference period.
- 4.6 In order to produce the report the CAA will require ANSPs to report their performance to us in line with any guidance published by the Commission. Current guidance is for performance data in a year to be provided by no later than 1 April in the following year.<sup>7</sup> This will ensure sufficient time for the CAA to assess the level of performance against the targets and consider the implications for any remedial action.

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<sup>7</sup> For example performance data for 2015 will need to be provided no later than 1 April 2016.

- 4.7 It is expected that ANSP performance reports will align with Commission guidance and reporting requirements set out in the Performance Scheme and Common Requirements legislation, and as a minimum contain:
- performance to date against the targets (presented in the appropriate format);
  - for targets that have not been met, explanations why this is the case and any action that has been taken to correct it; and
  - an indication of whether targets will be met in the following year, highlighting, as appropriate, any foreseeable impediments to the delivery of the targets.
- 4.8 Under Article 18(2) of the performance regulation where the Commission witnesses a significant and persistent drop in performance, it may require the Member State to define, apply and inform the Commission of corrective measures designed to achieve the performance targets. In the UK this means that the CAA would produce, on behalf of the DfT and in consultation with the airport operator and the ANSP, a corrective action plan aimed at addressing the underperformance.
- 4.9 The CAA considers a persistent drop in performance to be one that is taking place over at least two years. Where concerns are highlighted, the CAA would expect in the first instance that the airport operator would take steps through its rights under contract, where that is not possible or the CAA does not see any improvement it will seek to develop a corrective action plan.
- 4.10 The CAA does not envisage a direct role in the drafting of the corrective action plan by the airline community. However in reaching its decision it will endeavour to engage the relevant airport's airline consultative committee, as appropriate, in understanding the potential causes of the failing target.