House of Commons

Committee of Public Accounts

The Public Private Partnership for National Air Traffic Services Ltd

Forty-eighth Report of Session 2002–03

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/parliamentary_committees/committee_of_public_accounts.cfm. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Leslie Young (Committee Assistant), and Ronnie Jefferson (Secretary).

Contacts

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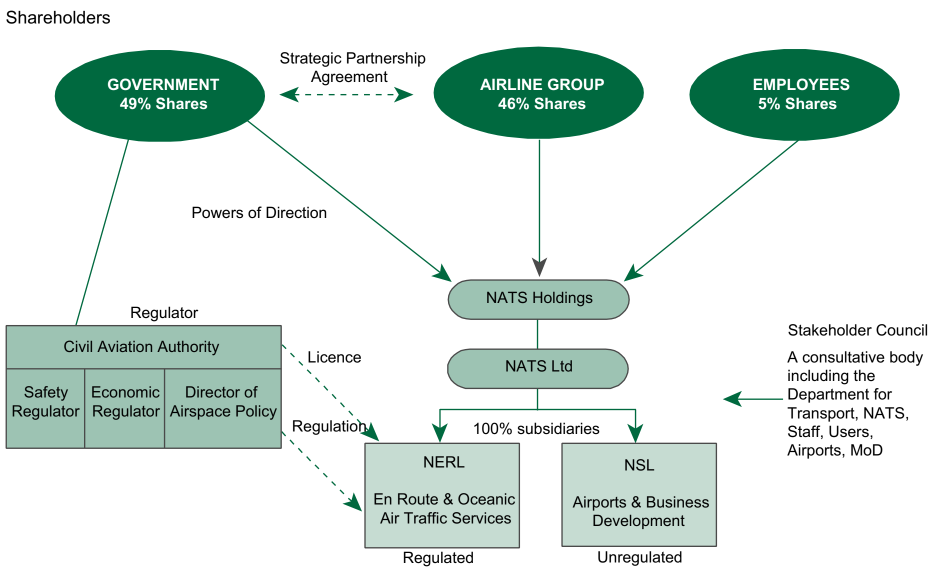
Summary

Introduction

National Air Traffic Services (NATS) is the company which provides air traffic control for aircraft flying over the United Kingdom, and with its Irish counterpart, the North East Atlantic. In July 2001 the Transport Department concluded a Public Private Partnership (PPP) with the Airline Group, a consortium of seven UK-based airlines, giving the Group operational control and a 46% share of NATS (**Figure 1**). Proceeds were nearly £800 million, of which £65 million came from the Airline Group and the rest from bank loans that are repayable by NATS itself. As a privatised body, NATS' prices are subject to economic regulation by the Civil Aviation Authority. The structure of the PPP has affected its ability to develop its business and finance its £1 billion investment programme over the next ten years. Events following September 11th 2001 have highlighted these risks.[1]

Figure 1: The PPP structure



On the basis of a Report by the Comptroller and Auditor General,[2] the Committee took evidence from the Department for Transport and NATS on four main issues: the choice of a PPP as the best option for the Company; the testing that was done on the Airline Group's financial proposals; the implications of the financial structure that is now in place; and the prospects for the Company.

The Department preferred the option of establishing NATS as a profit-seeking, but regulated company, rather than a not-for-profit model such as that used for the privatised national air traffic control business in Canada. The Canadian model was dismissed too readily. The regulatory arrangements, copied from the regulated utilities, have been shown

1 C&AG's Report, *The Public Private Partnership for NATS* (HC 1096, Session 2001–02) paras 1, 4

2 *ibid*, 24 July 2002

to take insufficient account of the very different business risks which NATS faces.

The Department failed adequately to test the robustness of the Airline Group's proposed financial structure for NATS. The set of scenarios examined was more optimistic than historical experience warranted, and imprudently assumed that the Regulator would always be both willing and able to intervene quickly to protect NATS from any sudden business downturn.

The Department and Treasury took £758 million out of NATS in sale proceeds, leaving the Company burdened with over twice as much debt as it carried before the PPP. The Company's financial difficulties cannot be wholly attributed to the after-effects of September 11th: the Economic Regulator expressed concern at the indebtedness of NATS before those events.

One of the Department's main reasons for preferring the profit-seeking but regulated company model for NATS rather than the Canadian not-for-profit model was to give NATS freedom to invest outside public sector financial controls. In the event, the chosen regulatory structure, combined with the high withdrawal of cash from the business, barred NATS from access to external finance for over a year, just when it was embarking on a ten year £1 billion investment plan.

Conclusions and recommendations

The choice of a public private partnership for NATS

1. The Department rejected the option of a not for profit corporation on the grounds that such a body would be less efficient and its expenditure would be classified to the public sector. Its reasons look even weaker now than they did then. There is growing evidence of the successful use of a not for profit model for Canada's air traffic control system. And in 2002 the Office of National Statistics classified the not for profit Network Rail to the private sector. Departments should evaluate all options thoroughly, and base their conclusions on objective evidence.

2. NATS' prices are capped through the RPI-X model developed for relatively predictable domestic utilities like gas and water supply. Only belatedly are NATS' price controls being modified to reflect the greater risks from exposure to volatility in international air traffic. PPPs and privatisations should not just be based on standard approaches, but should be tailored to reflect the particular characteristics of the business.

3. The Department accepted that NATS looked inherently riskier than a utility like water, but how risky depended on the Regulator, and was difficult to determine in the absence of clearly stated regulatory policy which was only now being agreed. We agree with this view from the Department, which is however hard to reconcile with its assumption, when testing NATS' financial robustness, that no financial risk for NATS would arise from the behaviour of the Regulator.

Testing the Airline Group's financial proposals

4. Of the nineteen scenarios modelled by the Department's advisers and by the Airline Group, only one catered for the risk of a (brief) downturn in NATS' income from traffic. The Department ignored historical evidence of downturns in air traffic. Scenario testing should be designed to reflect the main exposures to risk of the entity concerned.

5. In limiting their testing, the Department and their advisers drew comfort from the optimism of the Airline Group and its four funding banks. Departments should recognise that private sector entities investing in essential public services will have divergent objectives, and may well assume that the government and the consumer will bear the brunt of adverse events.

6. The arrangements for obtaining a price increase are inherently slow to implement and uncertain as to outcome. In practice the Regulator has required a more comprehensive solution which shares the pain between NATS, its investors, and its customers. Until such a solution is negotiated, NATS is unable to access the commercial funds it requires to invest in new capacity. Nor can it be assumed that the Regulator would be able and willing promptly to bail out NATS in the event of a severe downturn in traffic.

7. A proper appreciation of the regulatory risk facing NATS might have led the Department to leave more cash in NATS and thus avoid the current financial difficulties that NATS faces. When departments analyse risk, they should take care that their analysis is comprehensive and not based on unwarranted optimism.

The financial structure that was imposed on NATS

8. The maximisation of sale proceeds seems to have taken precedence over the financial robustness of NATS. No operable contingency plan existed to cope with the risk of a severe and sustained downturn in air traffic. Departments undertaking deals should ensure that such plans exist and that financial structures are robust enough to support them.

9. The Airline Group acquired a 46% share, a majority on the Board and operational control of NATS despite having paid only one sixteenth of the purchase price, the rest being financed by loans repayable by NATS itself. Departments undertaking PPPs should ensure that their chosen strategic partners accept risk commensurate with their control of the business and the accompanying responsibilities.

10. The Airline Group declined to provide NATS with further financial support. Leaving only the government shareholder to meet such financial requirements is difficult to reconcile with the concept of risk sharing in public / private partnerships.

1 The choice of a Public Private Partnership for NATS

1. The Transport Department and the Treasury, saw a PPP as the best way to develop NATS' business and to meet the Government's main objectives:

- To at least maintain standards of safety and national security;
- To obtain an injection of private sector money and skills;
- To develop NATS' business with greater freedom to invest outside normal public sector spending constraints; and
- To safeguard the interests of the taxpayer.[3]

2. The Government rejected the option of a not-for-profit corporation, as pioneered since 1996 by NavCanada, NATS' Canadian equivalent. This model was widely cited as an alternative to the PPP during the passage of enabling legislation through Parliament in 2000. The Department believed at the time that the particular structure of NavCanada would not result in NATS' expenditure being classified to the private sector and would not therefore provide the freedom to invest that was required. The Department was also concerned that without the profit motive the model lacked the usual spurs to efficiency.[4]

3. The Department and the Treasury considered that the PPP was the best way of improving the efficiency of NATS, which has the highest charges in Europe. More of the Company's resources need to be put into frontline operations. At the moment, just fewer than 2,000 of its 5,800 staff are air traffic controllers, and only 1,400 of those are active, the others being in training. The Department also considered that new investors would look at whether NATS brought projects in on time and budget and got benefits from them, areas where the Company had not been successful in the past. NATS is now accountable for its performance in new ways: to the capital markets for the money it seeks, to its shareholders, to the Economic Regulator and to a stakeholder council. Under this scrutiny it has spent a lot of time improving its procurement arrangements, and has brought human resources and facilities management into single organisations rather than having them scattered through the business.[5]

4. NavCanada too has demonstrated its ability to improve upon the levels of efficiency it achieved under public ownership. The Department conceded that the difference between the PPP and the not for profit model is not as great as had been thought. Its mind was not closed on these matters. But much time, trouble, Parliamentary time and money has been taken to construct the PPP and it would be a serious matter to abandon it now in favour of another model.[6]

3 C&AG's Report, summary para 2

4 *ibid*, para 1.7

5 Qq 123–129

6 C&AG's Report, para 1.8 and Appendix 3; Qq 2–3, 61–64, 71

5. The Department still saw very significant benefits in the PPP structure. For example, every other air traffic control body in Europe and North America has responded to the downturn since September 11th by raising prices, sometimes by very significant amounts. The average increase in Europe last January was 12%. These bodies are not subject to economic regulation of the type that is part of the NATS PPP.[7]

6. The PPP operates within the standard UK model of utility regulation, the RPI-X price regime. Under this method, regulators set price or revenue limits every four or five years, which they judge will enable the companies to deliver the services expected of them. This approach ensures that prices change in a predictable way and usually less than retail price inflation. Most experience in using RPI-X has been in domestic utilities, though the Civil Aviation Authority also uses it in regulating charges to airlines at UK airports.[8]

7. There are also other difficulties with the NATS price regime. It reduces NATS' income when airlines move to smaller aircraft, even though the cost of providing control is not influenced by size. To increase its charges above the limits set by the price cap, NATS must apply formally to the Civil Aviation Authority, await the outcome of a process of consultation which will take several months, and then await the next annual "window" of opportunity in which prices are changed across Europe. The Regulator has now proposed a major modification to the price cap, so that NATS will only bear up to half of the loss of income from unexpected reductions in the volume of business.[9]

7 Qq 96, 99

8 C&AG's Report, para 3.3

9 *ibid,* paras 3.31– 3.32; Civil Aviation Authority: Decision under Section 11 of the Transport Act 2000, NATS en route charges control, 20 December 2002

2 Testing the Airline Group's Financial Proposals

8. The strong competition between the two final bidders for NATS, the Airline Group and Nimbus, drove up the sale proceeds to the limit of what these bidders considered the business could sustain, based on their assumptions about growth in traffic and the need for further investment. As a result of the PPP, the level of debt within NATS rose from £330 million to £733 million. Debt would rise further over the next twenty years as the Company would draw on an additional £715 million of loans to invest in new air traffic control capacity (**Figure 2**).[10]

9. The Civil Aviation Authority and NATS expressed concerns to the Department that the increased indebtedness of NATS was unlikely to be sustainable. Whilst recognising the Regulator's perspective, the Department and its advisers assessed NATS' indebtedness under the Airline Group's proposals by testing whether the business would have sufficient cash flow to meet its debt obligations, in a range of scenarios. Of the nine scenarios mandated by the Department, only one dealt with an adverse trend in traffic, in terms of the risk that annual growth in traffic would be 3.5% compared to 6.7% in the baseline. Of the ten further scenarios done by the Airline Group and shared with the Department, only one considered lower than expected traffic; in terms of a downturn during the sixth year of the PPP, on the limited scale that was experienced during the Gulf War.[11]

Figure 2: How the PPP was financed

To finance the PPP deal, NATS' indebtedness rose from £330 million to £733 million

Sources of funds	**£ million**	
Cash from the seven Airline Group shareholders	50	
Strategic Partner Loan from British Airways	15	
Cash in NATS at completion	3.5	
Bank loans for the acquisition, repayable by NATS	733	
Less loan hedging costs	-7	
Total available funds		**794.5**
Uses of the above funds		
Purchase of equity stake from government	65	
Repayment of NATS' existing National Loans Fund debts	330	
Purchase of stake in NATS from government	370	
Less loan hedging costs	-7	
Government's immediate cash proceeds		**758**
Banking costs	33	
Cash left in NATS	3.5	
Total funds used		**794.5**

Source: C&AG's Report, page 37

10. The Department considered that that the testing performed had been extensive and thorough, but did not claim that every possible scenario was tested. In the circumstances before September 11th, the world appeared a less risky place than it would today. The expectations for future traffic growth were different. Every year since 1983 there had been a strong consistent picture of upward growth in NATS' market, except for the relatively

10 C&AG's Report, para 3.19

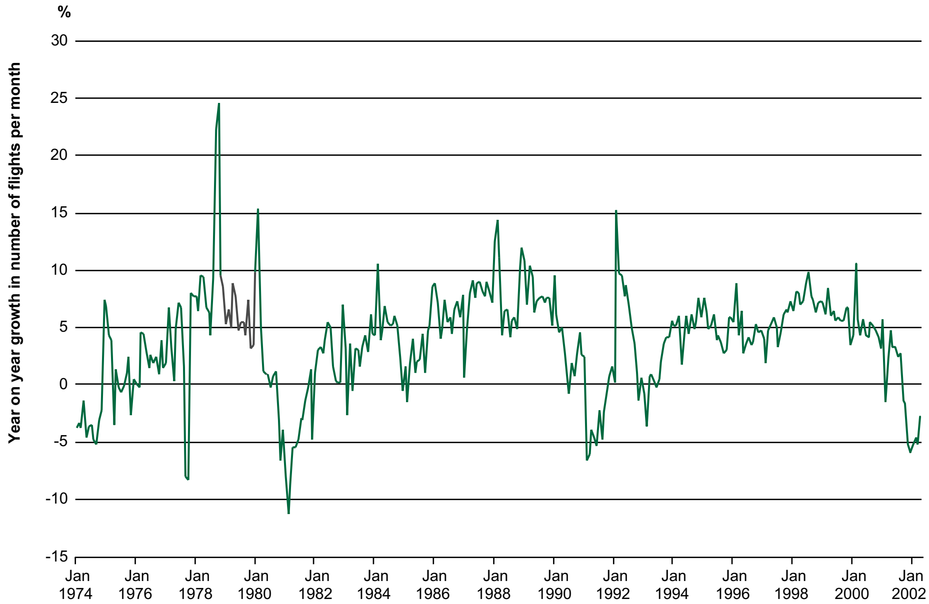
11 *ibid*, para 3.20, 3.23–3.24

minor downturn during the Gulf War. The new Chief Executive of NATS came into the job on completion of the PPP and had looked at the testing that had been done. He had considered before September 11th 2001 that the financing was going to be tight, but looked feasible.[12]

11. The Department, the Airline Group and their advisers did not test the PPP's finances against a repetition of the oil crisis scenarios of the 1970s and early 1980s (**Figure 3**). The Department regarded the two traffic scenarios that had been tested, based on the Gulf War and on sustained low growth, as severe but more relevant. In both of these scenarios NATS did not run out of money.[13]

Figure 3: The volatility of UK air traffic levels, 1974–2002

Traffic volumes are largely out of NATS' control, and can be highly volatile, leading to sudden changes in revenue



Source: NATS

12. The National Audit Office tested the PPP finances against a repetition of the Oil Crises and found that the PPP deal would not have been robust in those circumstances. The Department did not challenge this conclusion when agreeing the National Audit Office report, only questioning whether events so long ago were a good guide to what might happen in the future. The Report, which the Department agreed to in the normal way, presented the conclusions arising from this analysis. The Accounting Officer nevertheless questioned the conclusion during our hearing. In a subsequent note, the Department retracted some of the doubts that it had raised about the National Audit Office's reconstruction of traffic data. Its main continuing disagreement was that the National Audit Office test had not assumed that the Economic Regulator would allow NATS' prices to increase if there were to be a major and sustained downturn in traffic.[14]

12 Qq 8–9, 51, 93

13 Qq 227, 234

14 Ev 26–27

13. Contrary to the Department's assumption when testing the Airline Group's proposals, however, obtaining and implementing price increases for NATS is problematic and uncertain, and far from automatic. To increase its charges above the limits set by the price cap, NATS must formally apply to the Civil Aviation Authority. The review process must follow formal procedures of consultation and consideration. Practically this means delays of several months, and another constraint is that charges are normally set in Europe only once a year. If NATS and the Regulator cannot agree on an increase before prices are set in late November for the following calendar year, the Company will probably have to wait a further year.[15]

14. Following September 11th 2001, NATS applied to the Regulator in February 2002 for a price increase to take effect from January 2003. The Regulator announced its initial determination in May 2002 and in December 2002 agreed to an increase in prices, but only subject to NATS achieving a more appropriate debt structure than that established through the PPP. The Regulator's decision has been opposed by some of NATS' customers, including Ryanair.[16]

15 C&AG's Report, para 3.32

16 Ev 1, 26–27; C&AG's Report, para 3.32; decision by the Civil Aviation Authority under the Transport Act 2000, 20 December 2002; Ev 24–26

3 The Financial Structure Established for NATS

15. The financing of the NATS Public Private Partnership is shown at Figure 2 above. The Government took some £758 million out of the Company, well in excess of the £500 million receipts that had been predicted in the Government's expenditure projections. The Department still considered that in accepting the Airline Group's bid it had taken a balanced view of all the evaluation criteria, not just the proceeds. The main objectives had been to provide a viable way forward for NATS and to ensure that safety, security and public accountability were adequately addressed.[17]

16. These higher than expected proceeds were nearly all financed by bank debt repayable by NATS itself. Such a highly geared financial structure was in line with what some utilities, notably in the water sector, were adopting at that time. Other bidders, notably Nimbus, also proposed increasing the indebtedness of the Company, though not to the extent arranged by the Airline Group. The deal was structured this way because the business was seen as having a strong income stream. But the size of the debt means that debt interest payments since the PPP are running at over £50 million a year, nearly 10% of its turnover, even before it has drawn on its loan facilities for new capital investment.[18]

17. From the outset the Airline Group put relatively little of its own money into the Company, in the form of £50 million of equity and £15 million of shareholders loans, the latter also repayable by NATS. In effect the Group has acquired a 46% share and operational control of the Company having paid only one sixteenth of the purchase price, though a business encumbered with this much debt will generate less in dividends for the shareholders.[19]

18. Since September 11th the members of the Group have been affected by the downturn in aviation and have refused to put more money into NATS, and the Department has accepted that it is now a question of what the Group can afford. The seven members of the Airline Group pay about 25% of NATS' charges to airlines, so to that extent they will also benefit from any financial solution which helps NATS at the expense of the Government or the banks, rather than through increases in charges.[20]

19. In the absence of a contribution from the Airline Group, the Government has said that it will match, as a responsible shareholder, contributions from another equity shareholder, but will not go further. The current proposal is that the Government and a new investor, BAA plc will each contribute £65 million of additional equity as part of a wider solution involving the Company's banks and the Economic Regulator. The details of the agreement were still being finalised.[21]

17 Qq 4, 135, 151

18 Qq 10, 30, 32, 37, 55; C&AG's Report, para 1.38; Ev 31 (ref Q 218)

19 Qq 5, 10–11, 18, 20–23, 33–36, 139–143, 230, 231

20 Qq 11, 20–23, 36, 155–159

21 Qq 153–154, 160–161

4 The Prospects for the Company

20. So far, since the PPP, NATS has managed to generate enough cash internally to meet most of its investment needs, and the lack of access to bank funds has not been too serious. Its capital spending in the year 2001/02 was £64 million, not a great deal less than it had been planning before September 11th. It expects to spend about £50 million in 2002/03. The main immediate effect of September 11th on the NATS business plan was to postpone the opening of the New Scottish Centre at Prestwick from 2007, probably to 2009. But NATS has not stopped growing new capacity. In the near term the Company intends to increase the number of control sectors, to distribute the work amongst a greater number of controllers. A major exercise to give additional capacity in the North Sea is expected to come on stream in March 2003, to ease a current constraint there and to meet some military needs. The new management has used the last year to think through the risks and opportunities of investment in future systems and how NATS might collaborate with key partners in Europe.[22]

21. NATS was reasonably confident that the current difficulties of a lack of external investment would not lead to a risk of demand exceeding capacity, as long as the financial issues could be resolved in the next few months, balancing the interests of existing and new shareholders, lending banks, the Government shareholder and employees. Following the CAA's decision on raising NATS' prices, the Company needed the financial solution to be finalised so that it could continue to move forward.[23]

22. The risks to the delivery of new air traffic control capacity are not exclusively financial ones. It appears that NATS does not have enough controllers now, even before an expansion in the number of control sectors. In summer 2002 it was 34 controllers short, though it hoped to reduce this shortfall to 12 by peak time this summer. Operational staff at Swanwick are owed, on average, 10 days annual leave, of which about half can be attributed directly to training to convert to the systems at this new centre. The Company has instituted a scheme to buy back outstanding annual leave on a voluntary basis. Around 120 staff have volunteered for additional overtime.[24]

23. NATS plans to increase the number of controllers from 1421 in 2001 to 1617 in 2011, but many controllers are due to retire in the next few years and the annual intake of trainee controllers will only be increased from 120 to 130. NATS considers that current trainee pass rates are unacceptable and its aspiration is to achieve higher rates and shortened training.[25]

24. The structure of the PPP provides for an exceptional user contribution in unforeseeable circumstances. The Secretary of State for Transport or the Civil Aviation Authority may apply to the Courts for an "air traffic administration order" on the same lines as in the rail industry. An order would give powers to the Crown shareholder in the event of a failure by NATS to meet its responsibilities. There is a wide range of things that could be done if

22 Qq 13, 75–76; C&AG's Report, para 3.15

23 Qq 13–14, 95; C&AG's Report, para 3.29

24 Ev 24–26; Qq 188–197; Ev 26–28

25 C&AG's Report, paras 3.10, 3.12; Qq 111–113

NATS got into serious difficulties, but the Department felt it had reasonable grounds for supposing that a composite financial solution would be in place shortly. A return to public ownership looked unlikely.[26]

25. In March 2003 the Department informed us of revised financial arrangements for NATS. This solution envisaged a refinancing through the issue of long term debt in the capital markets.[27]

26. NATS is subject to safety regulation by the Civil Aviation Authority which licences its operations. We asked NATS whether doubts over safety at Swanwick were the reason why the Authority had given NATS only a time-limited approval to operate. NATS denied this, stating that they thought their approval from the Authority was indefinite. But it is clear from subsequent evidence that NATS approvals were time-limited until the Authority issued a permanent approval on 1st February 2003. The Civil Aviation Authority has since made it clear that their initial approval had been time limited because they had expected the new owners to make changes to the NATS' corporate management structure, and the Authority wanted to allow time for any changes to be identified and to stabilise fully. Following a satisfactory audit by the Authority, a continuous approval was given. The limitation was not associated with Swanwick or the general provision of a safe operational service.[28]

27. Allowing aircraft efficient flight paths is an important aspect of NATS' operational performance. NATS has stated that it has not measured the extent to which it restricts the flight paths of aircraft through "height capping", including the extent to which this has increased since the new centre opened at Swanwick.[29] But information from the European Air Traffic Control Agency Eurocontrol indicates that there was a marked increase in flight level restrictions from July 2002, when Swanwick faced its first summer of operation.[30]

26 Qq 40, 72–74; C&AG's Report, para 4.6

27 Ev 37

28 Qq 207–214; Ev 31 (ref Qq 201–215), 41–42

29 Qq 215–217; Ev 31

30 Ev 39–40

Formal minutes

Wednesday 19 November 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan
Mr Richard Bacon
Mr Brian Jenkins
Mr Gerry Steinberg
Jon Trickett
Mr Alan Williams

The Committee deliberated.

Draft Report (The Public Private Partnership for National Air Traffic Services Ltd), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 27 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Forty-eighth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

Adjourned until Wednesday 26 November at 3.30 pm

Witnesses

List of written evidence

List of Reports from the Committee of Public Accounts Session 2002–03

First Report	Collecting the television licence fee	HC 118 *(Cm 5770)*
Second Report	Dealing with pollution from ships	HC 119 *(Cm 5770)*
Third Report	Tobacco Smuggling	HC 143 *(Cm 5770)*
Fourth Report	Private Finance Initiative: redevelopment of MOD Main Building	HC 298 *(Cm 5789)*
Fifth Report	The 2001 outbreak of Foot and Mouth Disease	HC 487 *(Cm 5801)*
Sixth Report	Ministry of Defence: Exercise Saif Sareea II	HC 502 *(Cm 5801)*
Seventh Report	Excess Votes 2001–02	HC 503 *(N/A)*
Eighth Report	Excess Votes (Northern Ireland) 2001–02	HC 504 *(N/A)*
Ninth Report	The Office for National Statistics: outsourcing the 2001 Census	HC 543 *(Cm 5801)*
Tenth Report	Individual Learning Accounts	HC 544 *(Cm 5802)*
Eleventh Report	Facing the challenge: NHS emergency planning in England	HC 545 *(Cm 5802)*
Twelfth Report	Tackling pensioner poverty: encouraging take-up of entitlements	HC 565 *(Cm 5802)*
Thirteenth Report	Ministry of Defence: progress in reducing stocks	HC 566 *(Cm 5849)*
Fourteenth Report	Royal Mint Trading Fund 2001–02 Accounts	HC 588 *(Cm 5802)*
Fifteenth Report	Opra: tackling the risks to pension scheme members	HC 589 *(Cm 5802)*
Sixteenth Report	Improving public services through innovation: the Invest to Save Budget	HC 170 *(Cm 5823)*
Seventeenth Report	Helping victims and witnesses: the work of Victim Support	HC 635 *(Cm 5823)*
Eighteenth Report	Reaping the rewards of agricultural research	HC 414 *(Cm 5823)*
Nineteenth Report	The PFI contract for the redevelopment of West Middlesex University Hospital	HC 155 *(Cm 5961)*
Twentieth Report	Better public services through call centres	HC 373 *(Cm 5961)*
Twenty-first Report	The operations of HM Customs and Excise in 2001–02	HC 398 *(Cm 5961)*
Twenty-second Report	PFI refinancing update	HC 203 *(Cm 5984)*
Twenty-third Report	Innovation in the NHS—the acquisition of the Heart Hospital	HC 299 *(Cm 5961)*
Twenty-fourth Report	Community Legal Service: the introduction of contracting	HC 185 *(Cm 5961)*
Twenty-fifth Report	Protecting the public from waste	HC 352 *(Cm 5961)*
Twenty-sixth Report	Safety, quality, efficacy: regulating medicines in the UK	HC 505 *(Cm 5962)*
Twenty-seventh Report	The management of substitution cover for teachers	HC 473
Twenty-eighth Report	Delivering better value for money from the Private Finance Initiative	HC 764 *(Cm 5984)*
Twenty-ninth	Inland Revenue: Tax Credits and tax debt	HC 332 *(Cm 5962)*

Report	management	
Thirtieth Report	Department for International Development: maximising impact in the water sector	HC 446 *(Cm 5962)*
Thirty-first Report	Tackling Benefit Fraud	HC 488 *(Cm 5962)*
Thirty-second Report	The Highways Agency: Maintaining England's motorways and trunk roads	HC 556 *(Cm 5962)*
Thirty-third Report	Ensuring the effective discharge of older patients from NHS acute hospitals	HC 459 *(Cm 6016)*
Thirty-fourth Report	The Office of Fair Trading: progress in protecting consumers' interests	HC 546 *(Cm 5962)*
Thirty-fifth Report	PFI Construction Performance	HC 567 *(Cm 5984)*
Thirty-sixth Report	Improving service quality: Action in response to the Inherited SERPS problem	HC 616 *(Cm 5963)*
Thirty-seventh Report	Ministry of Defence: The construction of nuclear submarine facilities at Devonport	HC 636 *(Cm 6016)*
Thirty-eighth Report	Department of Trade and Industry: Regulation of weights and measures	HC 581 *(Cm 5963)*
Thirty-ninth Report	A safer place to work: Protecting NHS hospital and ambulance staff from violence and aggression	HC 641 *(Cm 5963)*
Fortieth Report	Improving social housing through transfer	HC 590 *(Cm 5963)*
Forty-first Report	Modernising procurement in the Prison Service	HC 676 *(Cm 6016)*
Forty-second Report	A safer place to work: Improving the management of health and safety risks to staff in NHS trusts	HC 704
Forty-third Report	Fisheries enforcement in England	HC 752
Forty-fourth Report	New IT systems for Magistrates' Courts: the Libra project	HC 434
Forty-fifth Report	Protecting public health and consumer interests in relation to food: the Food Standards Agency	HC 708
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Forty-seventh Report	Film Council: Improving access to, and education about, the moving image through the British Film Institute	HC 685
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Forty-ninth Report	The operational performance of PFI prisons	HC 904

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

MINUTES OF EVIDENCE

TAKEN BEFORE THE COMMITTEE OF PUBLIC ACCOUNTS

MONDAY 18 NOVEMBER 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr Ian Davidson
Geraint Davies
Angela Eagle
Mr George Howarth
Mr Brian Jenkins
Mr George Osborne
Mr David Rendel
Mr Alan Williams

Memorandum submitted by the Department for Transport

1. The Committee is due to take evidence on 18 November on the Report by the Comptroller and Auditor General on the Public Private Partnership for National Air Traffic Services Ltd (NATS) (HC 1096, Session 2001–02).

2. Part 3 of the Report sets out the position on NATS' future financing as it stood at the time of publication in July 2002. Since that time, there have been significant developments towards the strengthening of NATS' financial structure. The Committee may find it helpful to have this supplementary note.

3. Paragraph 3.32 refers to an application by NATS to the Civil Aviation Authority (CAA) as its economic regulator for a relaxation in the cap on NATS' charges to airlines, to reflect the reduced level of air traffic since the unprecedented events of 11 September 2001. NATS also sought other regulatory changes designed to give greater certainty about its income base in the remainder of the first five-year charging period and into the second. The application was part of a composite solution being developed by all the parties—NATS itself, its shareholders, a potential new private sector investor and NATS' lending banks.

4. Consideration of that application by the CAA has continued. Following the CAA's initial reaction in May 2002 noted in the report, NATS made further submissions to the CAA in June and September 2002. Discussions have continued in parallel on the composite solution.

5. NATS' confirmed in September that, as part of the composite solution, new investment had been offered on the lines set out in paragraph 3.38 of the Report. BAA plc was prepared to invest £65 million, partly as new equity and partly as debt. The Government was prepared to match an appropriate private sector investment on the same terms, and the composite solution would also involve some adjustment to the terms of the banks' lending to NATS.

6. The CAA issued a consultation paper to users about the regulatory changes sought by NATS on 17 October 2002. It indicated that it was minded to grant the changes sought by NATS, on condition that they would be part of the wider solution designed to secure a robust future for NATS and an equitable contribution from all parties. The CAA commended the proposed changes to users as a basis for reliable service provision in the future. The consultation period ends on 14 November, and the CAA will announce its conclusion thereafter.

7. If the CAA grants the relaxation sought by NATS, the value of X in the RPI-X charge setting formula will be two in each of 2003 and the following two years (instead of four in 2003 and five in the following two years as fixed at the outset of the PPP). This means that NATS will still be achieving real terms reductions in prices each year, and so reducing the cost of air traffic control services to airlines and thus ultimately to the travelling public. The CAA also proposed that NATS should no longer be exposed to the full risk of traffic fluctuations, and that a mechanism should therefore be introduced whereby NATS' prices would change if traffic differed from the levels forecast.

8. The Department welcomes the CAA's proposals, which it believes to be a firm foundation for NATS to plan ahead for safe and even more effective service delivery, and to expand to embrace other opportunities—particularly under the Single European Sky—as they arise. The Department is playing its part in seeking to complete the arrangements as quickly as possible.

5 November 2002

Memorandum submitted by National Air Traffic Services Ltd (NATS) PPP on NATS Performance in 2002

The Committee is to hold a hearing on Monday 18 November in connection with this inquiry. The purpose of this memorandum is to update the Committee on NATS' performance on safety and delays since the National Audit Office published its Report on the NATS PPP in July.

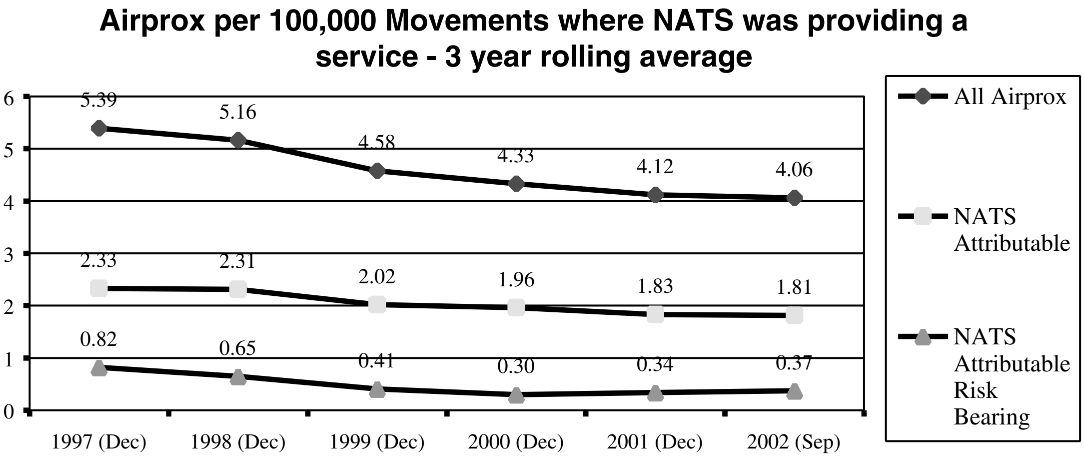
This has proved to be a challenging year for NATS, both financially and operationally. Traffic volumes have remained depressed following the events of 11 September 2001, particularly over the North Atlantic. Chargeable traffic in the financial year to date is running at 15.5% below the 2000 traffic forecasts on which the original price cap was based.

The low cost sector has, however, continued its strong growth. Such flights place heavy demands on air traffic control resources due in part to the short distances typically flown, and their concentration on particular routes. These flights generate significantly less revenue than heavy traffic and overflights.

We have taken steps to reduce costs, conserve cash and attract new capital. We have worked closely with our lenders and shareholders and sought a relaxation of the regulatory price-cap from the Civil Aviation Authority. The CAA's Consultation Document on our application to relax the cap was published on 17 October and we expect a final decision by the end of November.

Safety

Britain's skies are amongst the safest in the world and nothing has been or will be done that might jeopardise that position. Safety is our paramount priority and our safety record reflects the skill and dedication of our staff. All key indicators demonstrate that there has been a steady improvement in safety, despite large increases in traffic volumes over the last few years prior to 11 September. The following chart indicates the overall changes in safety levels over the last five years, taking account of the increase in traffic. The actual number of risk-bearing air proximity incidents attributable to NATS in the calendar year to date is six, compared to nine in all of 2001.

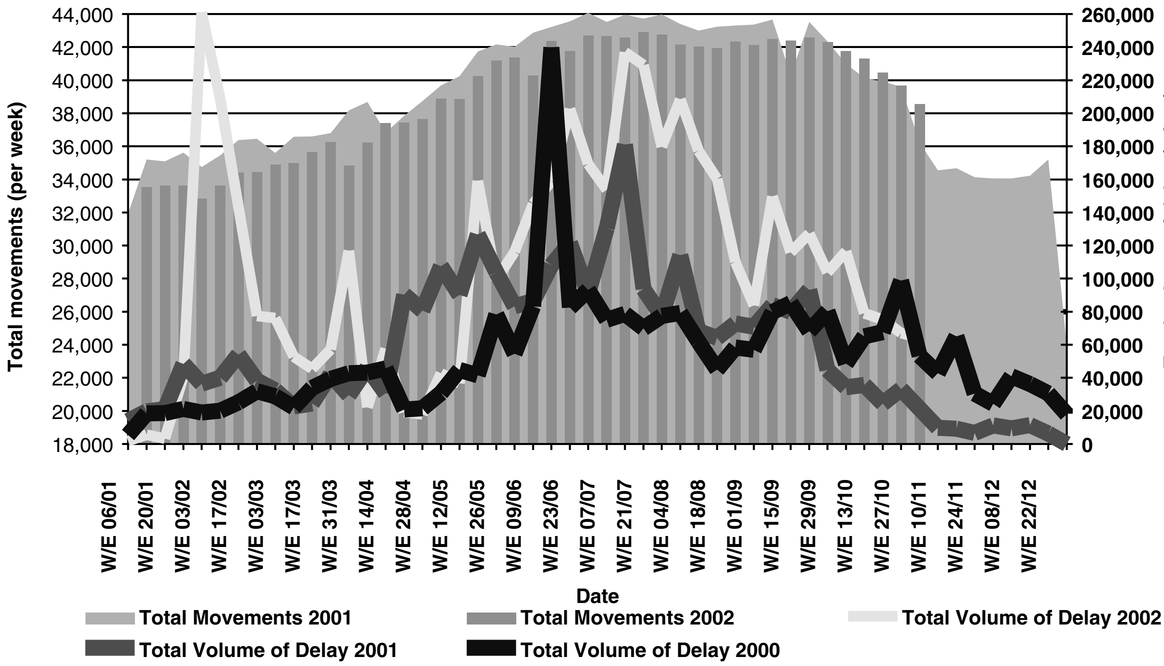


Delays

The average delay per flight attributable to NATS for the calendar year to date is 2.79 minutes, compared to 1.66 minutes in the corresponding period in 2001. NATS does not regard this as an acceptable performance. In part, it reflects the introduction of Swanwick into operational service in January, when flow rates were reduced to allow controllers to familiarise themselves fully with the new systems. However our performance in the summer was also disappointing, reflecting a shortage of manpower and capacity on key sectors. As a consequence, we are reviewing options for increasing manpower numbers and productivity. In the medium-term, we are increasing the overall number of controllers through our ongoing recruitment campaign, and aim to improve success rates through new methods of controller training including the increasing use of simulators. To meet requirements in the shorter term, we have recently concluded and implemented a new agreement with our controllers on voluntary overtime arrangements.

The chart below illustrates the progress we have made in reducing the delays to our customers in the latter part of the year. We are confident that these improvements will continue through the winter months and that we will have a range of measures in place to ensure a real improvement in performance in time for the start of next year's peak season.

Traffic movements compared to the extent of delay attributable to NATS



The immediate future is likely to remain challenging as airlines adjust to higher oil prices, the slow recovery of the world economy and the possibility of conflict in the Gulf. Despite the company's financial difficulties, the institutional arrangements established by the PPP have proved their resilience.

7 November 2002

Further Examination of Witnesses

MR TIM BURR, Deputy Comptroller and Auditor General, and MR JEREMY COLMAN, Assistant Auditor General, further examined.

MR BRIAN GLICKSMAN, Treasury Officer of Accounts, HM Treasury, further examined.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL:

The Public Private Partnership for National Air Traffic Services Ltd (NATS) (HC 1096)

Examination of Witnesses

MS RACHEL LOMAX, Permanent Secretary, and MR IAN MCBRAYNE, Head of Civil Aviation Division, Department for Transport and MR RICHARD EVERITT, Chief Executive, National Air Traffic Services Ltd, examined

Chairman

1. Good afternoon, ladies and gentlemen. Today we have a very important and serious subject. We are discussing the National Air Traffic Services which have been undertaken by a Public Private Partnership and there is considerable interest in this issue. We are delighted to welcome Rachel Lomax who has in the past been before us running a different department, but we congratulate you on taking on Transport earlier this year. Could you introduce your colleagues?

(*Ms Lomax*) Mr Richard Everitt, the chief executive of NATS, is on my right and on my left is Mr Ian McBrayne from the Department, who is the head of the Civil Aviation Division.

2. You have adopted a not for profit company solution for Network Rail or your Department has. Why did you object to it for NATS?

(*Ms Lomax*) This was discussed at great length when the Transport Bill was going through the House and I think the Treasury sent a memorandum to the Transport Select Committee. At the time, the Government felt that a PPP would provide a stronger commercial framework and would promote more efficiency than the untried and untested not for profits model which had only very recently been adopted in Canada. With the benefit of hindsight and given the strategic partner we have ended up with, the difference between the PPP and the not for profit

[**Chairman** *Cont*]

model is perhaps not as great as people thought at the time.

3. If you were making this decision now, a not for profit company might have been more of a runner?

(*Ms Lomax*) The arguments would have looked a bit more finely balanced, yes.

4. The Treasury were raising 500 million from this sale. In the event, you raised 800 million. This was raised mainly by debt which had to be repaid by NATS itself. Did the desire to take this much money out take priority over the long term viability of the deal?

(*Ms Lomax*) No. On the minor point first, the Department had no benefit at all from the receipts being so far in excess of the 500 million that had been taken into account at the time of the Comprehensive Spending Review. Naturally, the Department was concerned to get value for money for the taxpayer and was mindful of the points which have been made in this Committee about the need to do that. The major objectives of the PPP were to provide a viable way forward for NATS and to ensure that the concerns about safety, security and public accountability that had been expressed in Parliament were adequately addressed.

5. The airlines in the end put in very little money. £60 million?

(*Ms Lomax*) It was a highly leveraged structure that emerged from the PPP negotiations. It would have been the same if it had been any of the other bidders at that stage. This was pretty much in line with the sort of structure for regulated utilities that other sectors were adopting at that time. The water sector, for example, followed the lead of Glas Cymru. That very highly leveraged structure was something that was popular with other utilities.

6. In the event, we know that the whole thing has turned out very badly because of a sustained downturn in traffic. Why did you not test the robustness of the Airline Group's financial structure against a possible downturn? After all, there had been downturns in the past.

(*Ms Lomax*) There has been nothing on the scale and the severity of the downturn that followed 11 September. In terms of its impact on NATS' business, which is very dependent on large, long distance aircraft to generate income, in terms of chargeable service units, this downturn has been way in excess of anything that has been seen before. For example, the downturn following the Gulf War on a year on year basis in chargeable service units was 1%. For the last 12 months, it has been 11% .

7. You could have coped with the downturn you had after the Gulf War. That was the scenario you were looking at, was it?

(*Ms Lomax*) Yes.

8. You did look at these scenarios, did you?

(*Ms Lomax*) It was very extensively stress tested. Every scenario that people could think of to throw at these bids, was worked up. There were compulsory ones which our advisers suggested. Each of the bidders devised their own and we also did some in-house. That is not to say that every possible scenario that anyone could ever think of was tested because life is not like that. The honest truth is that, in the circumstances of the time, the world looked a less risky place than it does today.

9. Your advisers, CSFB, were giving you this useful advice about a possible downturn? You were paying them a lot of money, were you not?

(*Ms Lomax*) Yes, and they did a very great deal of work for it. Every year since data on chargeable service units has been collected, since 1983, there has been growth in that measure, which is of particular relevance to NATS, with the exception of the Gulf War when, as I mentioned, there was a relatively small downturn. It had been a very strong, consistent picture in upward growth in that market.

10. Your "partner", the Airline Group, has refused to put any more money in to produce more equity for NATS. It has been left to you to bail them out with £60 million of temporary finance. You are letting the airlines off very lightly, are you not? If there had not been this downturn, they would have got a profit. Now that there is a massive loss and we are in this appalling mess, they are walking away from it, are they not?

(*Ms Lomax*) September 11 has hit the aviation sector very hard, including the Airline Group. It is a question of what they can afford to do. The taxpayer is not picking up the whole consequence.

11. You and the banks, I should have said, are finding 60 million?

(*Ms Lomax*) Neither are users. The £60 million that you are talking about was a temporary facility that was put in place earlier this year which ran out at the end of September and has not been used. What is being worked up at the moment is a more lasting solution which the CAA and NATS are actively discussing. The CAA put out a consultation paper in the middle of October which has been out to consultation until last week. We are expecting a decision from them in a few weeks' time. The principle that they have adopted is that all parties—users, the Government and the banks—should be making a contribution to a lasting solution.

12. Mr Everitt, obviously you have a very good safety record. I do not think there has ever been a fatality in the UK because of a failure in air traffic control. Will this good performance be sustainable in the future given your difficulties in investing?

(*Mr Everitt*) Yes. I am determined it will be sustained and indeed improved. Our performance this year in terms of risk bearing air proxies is similar, perhaps slightly better than last year, although they have not been all fully assessed by the Airprox Board, which was in single figures. I am determined to improve on that. This is our absolute priority. That is what we are here for and whatever the financial situation we are determined to work on our safety record.

13. That is fine as far as it goes but you are also required, are you not, in your job to increase capacity? Because of the financial difficulties you find yourself under, you have not been able to do that at present. To what extent are you now being constrained in what you might have hoped to achieve over the next decade? When there is an upturn, we are

[**Chairman** *Cont*]

going to find there will be severe delays because you simply have not the resources to put the investment in.

(*Mr Everitt*) We have Swanwick and we have brought Swanwick into use very successfully in January. That is one of the principal drivers of our future capacity. The way we will increase capacity over the near term is to increase the number of sectors. Airspace is broken up into sectors, which enables us to distribute the work amongst a greater number of controllers. We are doing a major resectorisation which we anticipate coming on stream in March, which will give us additional capacity in the North Sea which is one of the big pinch points we have at the moment. It will also meet some military needs. We have not stopped growing capacity. We will also grow capacity through the Swanwick system as we bring additional controllers in. Where we have paused—and I stress "paused"—is in investment in our future sensor systems, but we have used this year to really think through the risks and the opportunities and how we might collaborate on future sensor systems. I am confident that once we are through this refinancing following the CAA's decision we can get on with some of these projects.

14. We know from paragraph 3.11 of this report that the project to increase air traffic capacity could take several years to implement. Are you telling us that the lack of investment that we are now seeing and the difficulties out there will not lead to a risk of demand exceeding capacity?

(*Mr Everitt*) I am reasonably confident that that is the case, as long as we can get these issues resolved in the next few months. We will have better projects. One of the things the PPP was set up for was to improve the project process within NATS and we have used this year to really think through what we can do and how we can manage the risk of these very, very complex projects more effectively. We have used this year well. What we now need is the composite solution to be put in place so that we can continue to move forward. I would stress that we spent, in the last financial year, £64 million on capital. This year, we will spend about 50 million, so we have not just stopped spending. We have just been careful how we use our money, given that we have had to live within our cash flow now for nearly 15 months.

Mr Williams

15. I want to establish to what extent the Treasury was in the driving seat. I ask this because the supplementary briefing we had just before the meeting updating us from the NAO makes the point that the Department and the Treasury decided to address the problem through a PPP. It says that the Department and the Treasury dismissed the option of a not for profit company. How much alternative did you really have as a Department? Was there any option on the table other than a PPP?

(*Ms Lomax*) It is not a question that I think I can answer. It goes to the question of discussions that were going on between ministers and departments which, even if I had been party to them, I would not want to reveal. On a major, controversial issue like this involving the ownership of a safety critical industry like NATS, I would be most surprised if the Department just did it off its own bat. It really does need to be agreed with the Treasury.

16. So that this is not taken out of my time, on a point of order, Chairman, I make the point that we have just had a witness who was not the Permanent Secretary at the time saying that she cannot answer because she was not there at the time. At an earlier meeting, I did ask that we have at this meeting the Permanent Secretary who was there for four relevant years. We do not have him here so I would hope that subsequently, at the end of this meeting—it is not your fault, Permanent Secretary—we can address this problem of us not being able to get answers because we have the wrong witnesses. That is not to in any way undermine the respect we have for the current witness. Looking through the report, I seem to miss a public sector comparator. Was there a public sector comparator?

(*Ms Lomax*) The way I see this—

17. Was there or was there not? We either have a comparator or we do not have a comparator. For all the others, we have had a comparator. It could be a fault on my part but I have not seen one in here and you have not seen one either, have you?

(*Ms Lomax*) No, I have not seen one.

18. In that case, it is not for you to answer because we can now go to the Treasury. Why are we in the situation where there is not a meaningful public sector comparator?

(*Mr Colman*) For many years, privatisations took place without any form of public sector comparators.

19. I am asking why there is not one in this case. This is particularly sensitive, being a highly political trail in advance. There was considerable criticism of the possibility of going this route. Why did you not protect the back of the Department and the Treasury by having a public sector comparator or did you not dare do it?

(*Mr Glicksman*) I have not seen a public sector comparator. I cannot answer your question directly.

(*Ms Lomax*) I do not think I would expect to see a public sector comparator in a case like this. You see them for PFI deals but I have never seen one for a privatisation. This was a share sale of 51% of the shares. It was a major policy decision and it went through the Houses of Parliament. The trouble about PFIs is that they do not have that sort of political scrutiny.

20. You did not have one and I have established that quite clearly. This was all about obtaining a one billion investment and you have been talking of 60 million last year and 50 million this year. You still have a very long way to go. The consortium paid 65 or 50 million? It is 46% of the business. If you look at table 11 the 65 million is made up of 50 million equity from the Airline Group and an additional loan. A loan to whom from the Airline Group and who was to pay it back? That made the 15 million to make it up to 65. What did they pay? 50 million or 65 million?

(*Ms Lomax*) They paid £50 million for an equity stake and then there was a £15 million loan from British Airways.

21. To who?

(*Ms Lomax*) It was paid into NATS.

[**Mr Williams** *Cont*]

22. Who pays it back?

(*Ms Lomax*) NATS will pay it back.

23. In other words, all they paid was £50 million to get 46% of the whole of this business?

(*Ms Lomax*) Yes.

24. That is absolutely unbelievable. That left NATS lumbered with a debt of £735 million which was quoted as part of the purchase price, although the purchaser never paid it, because you are having to pick up this bill, are you not, NATS?

(*Mr Everitt*) Yes. It is a debt of the company.

25. That is 735 million you are paying for them to buy your business. What about the interest on that 735 million? That does not include the interest charge as well, does it?

(*Mr Everitt*) Yes. We have a loan put in place as part of the restructuring of the finances of the company at completion. It is our job as a company to service that loan both in terms of interest and to repay it.

26. You are paying the interest as well?

(*Mr Everitt*) Yes.

27. Over 20 years, if it were 10%, that would be another £800 million and it is probably more than that, is it not?

(*Mr Everitt*) I think the interest rate is around 7% .

28. In that case, it is £600 million. In addition to paying back the 800 million, you are also lumbered with £600 million of interest charges, all to enable someone else to buy your business.

(*Mr Everitt*) It will be quite a lot less than that because we will be paying back part of the loan over the 20 years.

29. The average loan is 400 million. In 20 years it is £600 million so you are paying £1,400 million for someone else to buy half your business effectively. That is correct, is it not?

(*Mr Everitt*) The two shareholders, Her Majesty's Government and the Airline Group, structured the finances of the company at completion and determined that they would put this amount of debt in place. That represented the proceeds to the government—

30. That is not answering the question. The fact of the matter is that you are lumbered with a debt which is now making it impossible for you to borrow on the market even as easily as you could have done before the PPP. That is a fact, is it not?

(*Mr Everitt*) We have a large debt and that is making it difficult.

31. You are in a worse position than you were before you had a PPP and you are saddled with paying for someone else to buy it. Permanent Secretary, when this was up for grabs, did the bidders know that they would be able to offload the loan—I assume they must have done because it was part of the discussion—onto NATS?

(*Ms Lomax*) Yes.

32. One of the puzzling things is that the Treasury, who are usually pretty good at working out what they might get from a sell-off, were expecting 500 million. They got 800 million and they could not believe what was in their greedy little hands. Does it not in a way explain the situation because if the bidders knew that they could bid and it did not matter what they bid; NATS would pay, they could keep up bidding knowing NATS would pick up the bill. What the Treasury got was an actual receipt from a most deceptive and non-competitive way of selling a business on.

(*Ms Lomax*) There is a limit to the amount of debt that people would have saddled NATS with and that is the amount of debt which NATS was thought to be able to service out of its income. That is why the deals were structured in this way, because it was thought to have a very strong income flow.

33. Who represented the purchasers?

(*Ms Lomax*) The Airline Group.

34. Yes.

(*Ms Lomax*) They are not here.

35. That is another witness we could have done with. We are not doing very well at all today.

(*Ms Lomax*) The Airline Group put the bid in on the basis that they would not be taking dividends out. They are not looking to make a profit out of this.

36. You do not get 46% of a business when you have only paid one-sixteenth on purchase price. When you take into account that it is then a further twelfth it is also the interest element which brings us up to 14 million. It is one pound every £20-worth of purchase.

(*Ms Lomax*) There is an issue about how much a business carrying this much debt is going to be worth. The equity shareholders are the last in line. If the business is very encumbered with debt, there is going to be less for them even if they were going to take dividends out.

37. Treasury, since you only expected 500 million, why did you take the 800 million? Why did you not leave the other 300 million in to reduce the debt and therefore give NATS more flexibility?

(*Mr Glicksman*) 800 million was the amount that was offered by the best bid. It would be quite difficult to go back to them and say, "This is too much. We do not want so much money for this sale." What we were looking for was best value for money and there is no reason why this should not have been the best value for money.

38. It is the most flawed project I think I can ever remember coming before this Committee.

(*Ms Lomax*) Two valuations were done of NATS by PricewaterhouseCoopers as well as by CFSB, our advisers. They put the value on NATS at somewhere between 800 million and a billion. I would be in a very uncomfortable position indeed if I had come before this Committee and said that we deliberately decided to take 500 million when that was the valuation set on the deal by our advisers and independent valuers, supposing September 11 had not occurred. It is very difficult to justify to the Public Accounts Committee accepting a bid so far off the valuation that the market is putting on it.

Mr Rendel

39. Ms Lomax, is NATS going to survive in its present ownership pattern?

(*Ms Lomax*) I think so, yes. There is a refinancing going on at the moment as part of putting a composite solution in place, but by and large the PPP has emerged pretty well over the last year.

40. You are confident that we are not going to see another railway situation in which, in effect, the government has to take the thing back into public ownership?

(*Ms Lomax*) That looks unlikely at the moment, yes.

41. You said in answer to the Chairman, when he asked whether you tested for a downturn in the business, "There has never been a downturn on this scale" and that it was very extensively stress tested and that every scenario that people could think of was worked up. Could I ask you to look at page 38, figure 21, where you will see that, according to the NAO there was a number of scenarios tested by the Airline Group over and above those that had been requested, but a number of historic scenarios were not remodelled, including those three on the right there, the first oil shock, the second oil shock and the Gulf War. Presumably if those are historic scenarios, somebody could have thought of them and yet you said that every scenario that people could think of was worked up.

(*Ms Lomax*) The question that I think was asked, which is not exactly the same as testing these scenarios, was what sort of shock to airline traffic would cause this deal to fall apart. As I understand the advice given to me when I have asked this question, the answer was such a large shock that it was thought to be quite implausible.

42. I do not think that was the question. What the Chairman asked you was why did you not test for a downturn in business. You said that there had never been a downturn in business on this scale, which I understand, but there have been significant downturns in business, including the ones which showed that, for a few years at least, there was very little growth in air traffic as in the first oil shock and the second oil shock scenarios given here. Clearly, if those had been tested for, it would have given a very different picture of the ability of NATS to retain the chance to invest in the future and to take on more debt, which we now find it cannot take on.

(*Ms Lomax*) I do not think that is quite right. I think that downside scenarios were tested.

43. Not these.

(*Ms Lomax*) There was a prolonged period of low growth and individual shock in one year on the same scale as the Gulf War, which I am told we did test for.

44. If you look at the fifth column, "Lower Traffic in Year 6", I understand that it was insisted that they do a certain amount of testing of 3% growth as opposed to 6% growth, or 7%; I forget. Anyway, it is still growth of a considerable amount, whereas if you look at the scenarios, first oil shock and second oil shock, you get effectively no growth for three or four years. In the first oil shock case, you actually get a downturn and a positive drop in air traffic for the first four years.

(*Ms Lomax*) These are flights as opposed to the chargeable service units. These are not comparable data for—

45. On the left hand side it says "chargeable service units".

(*Ms Lomax*) I do not think they can be for the first and second oil shocks because comparable data do not exist before 1983.

46. You appear to be saying that this report is wrong. If it is wrong, you should have said so at the time.

(*Ms Lomax*) I think it actually says—

47. Could I ask the NAO?

(*Mr Colman*) I am as puzzled as you are. The chart is what it says, chargeable service units, and this report has been agreed in detail with the Department.

(*Ms Lomax*) I do not want to make a big thing about this because I think there are general points to be made. I am told you did not take account of all our comments.

48. Chairman, this seems to be quite serious. The witness is saying that she claimed that the report was wrong and that this has not been taken into account by the NAO. Therefore, there is still a conflict, apparently, between what the Department and the NAO are saying as to the truth of this Report.

(*Ms Lomax*) The important point to make is that very large numbers of scenarios were tested. They did include some downside scenarios. The ones that were tested—

49. Before we get back to that, there is a point which I want to investigate further as to what this means. The first thing we have to get at is whether this report is accurate or not. As far as I can understand the NAO, the NAO still thinks it is accurate. Are you saying that you hold that it is not accurate and that you told the NAO this and that, in your view, there is still a difference of opinion between yourselves and the NAO and yet this report has been allowed to go ahead?

(*Ms Lomax*) I do not want to pursue this.

50. I do want to. It is a very important point.

(*Ms Lomax*) It may be me who has got this wrong. I would much rather—

Chairman

51. Do you want to take a minute to take advice?

(*Ms Lomax*) Can we write to you?[1] We think it is flights that the data are showing here. If we failed to pursue the point sufficiently vigorously with the NAO at the time when we should have done, I apologise to the Committee. We need to beg the Committee's indulgence to follow this up afterwards. The general point I think I can make is that downside scenarios were tested. There was extensive testing by the bidders, by our advisers and for the benefit not just of the Department and the Treasury but also credit committees of four banks. This was a very thorough exercise. The issue that is worth thinking about is that, in the circumstances of May 2001, the world looked a safer place. The expectations for traffic growth were different. Even if you had said

[1] Ev 26–28.

[**Chairman** *Cont*]

then there could be an absolutely catastrophic development of the sort that September 11 precipitated, how much weight would you have put on that in deciding what was an acceptable price and an acceptable financial structure for NATS?

Mr Rendel: Chairman, I understand what the witness is saying but this is a serious matter. We have come up, apparently, with a disagreement between the NAO and the witness as to whether this report is accurate or not. It does make a difference to my further questioning because clearly if this report is accurate and what the witness was saying earlier in answer to you was not accurate, if she is now correcting what she is saying about this and the NAO have made a mistake, obviously that makes a difference to any further lines of questioning. We may wish to discuss afterwards as to whether we need to recall this witness at a later stage to answer these points once she has been able to hammer out with the NAO what is the truth of this matter.

Mr Williams: Or recall the Permanent Secretary who was there at the time.

Mr Rendel

52. I am a little unhappy that this should be answered by a note.

(*Mr Burr*) Whatever the basis of these figures, the point still remains that the scenarios in blue did not exhibit the patterns of the scenarios in grey.

53. I entirely take the point there but it seems to me that what the witness is saying is that the blue scenarios were calculated on a different basis from the grey scenarios. Perhaps we can go on with some other questions. To what extent do you feel that the privatisation transferred any risk of further problems from the public to the private sector or was it never intended to do that at all?

(*Ms Lomax*) The risk has clearly been transferred in the sense that, had NATS remained in the public sector, there would have been a choice of two possibilities to respond to the events of September 11. One, the Government could have picked up the whole tab. Two, the costs could have been passed straight on to users. The whole business about the composite solution is an attempt to find a way of spreading the adjustment across a wider collection of people.

54. May I ask you to turn to page 26, figure 14, because it indicates that the difference between the Airline Group and the Nimbus Group came out better in terms of Nimbus on three of the different criteria and better in terms of the Airline Group on two, of which one was the net sales proceeds. To what extent was it net sales proceeds that made the difference to the choice? Was that really your main criterion?

(*Ms Lomax*) No. The choice was made in the round. There was a small difference between the Airline Group and Nimbus at the end but it was only a few million. The Nimbus deal was different because Serco wanted to put their existing—

55. What was the difference of a few million?

(*Ms Lomax*) By the time the Airline Group's bid had been adjusted down, the difference in terms of the net sales proceeds between the Airline Group and Nimbus was quite small. The Nimbus Group also involved a great deal of debt for NATS, by the way, but it was different in some other respects.

56. Better in some respects?

(*Ms Lomax*) Yes, and also worse in some respects.

57. Including financial credibility and capacity, which sounds like exactly why the NATS bid has gone wrong.

(*Ms Lomax*) There were differences across all the criteria. For example, on certainty, clarity and conditionality, Nimbus was rated acceptable to poor.

58. Am I right in saying that effectively what happened was that the Airline Group, having been made the prime bidder, was able to gazump the government downwards at the last minute, when it was rather late to change your mind, and yet you suddenly discovered that they were offering a lower price for your goods than they had previously offered you?

(*Ms Lomax*) Nimbus did volunteer that they did not want to change their bid. This was against the background of foot and mouth and the impact that that was having on traffic forecasts.

59. You were gazumped?

(*Ms Lomax*) We prudently took account of what was happening in the outside world and I think we would have been criticised if we had not. Traffic forecasts were coming down. The questioning so far has suggested that we were so greedy for proceeds that we did not look hard to see whether it was a safe deal. We did take account of the fact that the world was changing and that the world economy was slowing, that foot and mouth was hitting the North Atlantic trade quite severely and that those were good reasons for allowing the Airline Group to revise its forecast down. Even so, it remained higher than the Nimbus Group and the Nimbus Group voluntarily decided they did not want to adjust their bid.

Chairman

60. That was rather a frustrating session because you signed off this report. When Permanent Secretaries sign off a report, we assume the departments have agreed the report. Either the Department signed up to this report and every fact, including the figures, or it has not. Otherwise, we get into a ridiculous situation. Are we basing our questions on inaccurate reports? Colleagues are frustrated. Personally, I am in the dark now. I asked you a simple question at the beginning of this meeting: did you take account of possible downturns? You said, "We could not possibly have foreseen there being a downturn after September 11." That is a fair enough answer. As I understood it, you said to me, "Yes, we did take account of what happened in the Gulf War and the oil shocks of 1973 and 1972." There now seems some doubt about this. I do not know about colleagues but I, for one, am confused.

(*Ms Lomax*) Could I have a shot at explaining? First of all, I apologise for appearing to criticise anything in the report at this stage. I should not have done it. It is out of order. The truth of the matter is that the amount of technical testing for a bid like this

[**Chairman** *Cont*]

is enormous. The NAO report may not be inaccurate so much as over-simplified. I stick completely to what I said to you at the beginning, which was that the impact of September 11 on the measure of airline traffic that matters to NATS' income was quite unprecedented. For the purposes of considering the present situation, that is a very important point. With the ink scarcely dry on the contract, with the PPP only seven weeks old, NATS was hit by a quite unprecedented shock.

Chairman: I am not sure that answers my question. I have made my point. You have promised us a note.[2] I do not really like dealing with notes because it is much better to resolve these things. Maybe, before the end of the meeting, we will get to the bottom of it. If we have not, I will ask you some more questions.

Mr Osborne

61. Can I turn to the answer you gave to the Chairman earlier about, to quote, the judgment now between a not for profit solution and the PPP would be more finely balanced with hindsight. Would you elaborate on that?

(*Ms Lomax*) There are two relevant points. One is that the NAVCANADA model, at the time when it was being cited as something that we should look to in structuring the future for NATS, was relatively recently introduced. It came in in 1996. It was difficult to use that. It was not a tested model. In practice, it turned out rather well. The second thing is that the strategic partner in the PPP is the Airline Group which has said that it wants to operate on a not for profit basis and it will not be looking to take dividends.

62. It is doing a good job of operating on a not for profit basis at the moment.

(*Ms Lomax*) I think that is very similar to most people in the aviation sector, is it not?

63. Your view is that it is now a more finely balanced decision between a not for profit organisation and a PPP; whereas at the time this legislation was going through Parliament it was amongst the most controversial legislation of the last Parliament. There was an enormous row about whether a not for profit solution would be better. You are now in effect saying that, with hindsight, you are not sure; maybe it would not; whereas the statements from ministers at the time were that the case for the PPP was overwhelming.

(*Ms Lomax*) The PPP is there. A lot of work has gone into it. It has been very carefully thought through. I was asked to say how could we therefore be going ahead with Network Rail which is a not for profit structure and I have indicated that people's minds are not closed on it. It was not a theological thing.

64. My colleague says it seemed like it at the time. If you read this Report, paragraph 1.7, page 12, the very last bit of the paragraph says, "The Department worked on the understanding that in the United Kingdom the particular structure of NAVCANADA would not result in NATS' expenditure being classified to the private sector and would not therefore provide the freedom to invest that was required." In other words, a not for profit NATS would appear on the Treasury's books. I am right in saying that Network Rail does not appear on the Treasury's books?

(*Ms Lomax*) If I could read the next sentence: "However, any definitive view would be subject to detailed assessment of the body's control and risk transfer arrangements." The same is true of Network Rail.

65. Once you had a detailed chat with the Treasury, you were able to put Network Rail off the Treasury's books.

(*Ms Lomax*) The decision to classify Network Rail the way it is does reflect a particular position that has been put forward about the control of Network Rail.

66. There does not seem to be a great deal of difference in principle between a not for profit operator of an air traffic control system and a not for profit operator of a railway system. The principle of the government's relationship with a not for profit organisation is there.

(*Ms Lomax*) One significant difference is that Network Rail is in receipt of a large amount of public subsidy; whereas NATS is not.

67. Relatively speaking, it is receiving quite a lot of soft Government loans, is it not?

(*Ms Lomax*) Is it? What soft Government loans? It is not in receipt of any soft Government loans.

68. It got 30 million earlier this year.

(*Ms Lomax*) Are we talking about Network Rail or NATS?

69. NATS. Was it not bailed out in March?

(*Ms Lomax*) No, not at all.

(*Mr Everitt*) In March a 60 million facility was put in place on commercial terms, subscribed 50/50 by the banks and the Government. That was designed to be working capital. It expired and was repayable by the end of September. We did not have to draw on it. Had we had to draw on it, it was on straight commercial terms.

70. Why did you need the Government as a partner? Why not go to the banks for the whole amount?

(*Mr Everitt*) That was the arrangement that was put in place between the Government as shareholder and the banks as funders. It was done on strict commercial terms because the banks would not do it in any other way.

71. Are you considering now a not for profit solution? Have you decided that now you have the PPP, come hell or high water, you are going to stick with it or are you considering another major change?

(*Ms Lomax*) No, we are certainly not thinking of another major change. There is no need to at the moment and having gone to so much time, trouble, parliamentary time and money to construct the PPP it would be a very serious decision indeed to abandon it.

72. Have you contingency planning in place in case, for example, revenues do not pick up and the downturn is more prolonged than you anticipate?

[2] Ev 26–28.

[**Mr Osborne** *Cont*]

(*Ms Lomax*) The structure of the PPP and the economic regulatory framework within which it is operating does provide for recourse if NATS gets into difficulties. For example, there is in the NATS licence a condition which provides for an exceptional user contribution in circumstances which could not have been foreseen. Prices could be raised. In the legislation, as you no doubt recall, there is provision for air administration on the same lines as rail. There is a wide range of things which could be done if NATS got into serious difficulties, but that is not where we are at the moment. We are negotiating a restructuring which will put us on a firm footing even in these difficult circumstances.

73. You are not doing any planning for those possible outcomes?

(*Ms Lomax*) We have plans against almost everything in the Department.

74. Some plans are more worked up than others.

(*Ms Lomax*) At the moment, we have reasonable grounds for supposing that a composite solution will be in place shortly.

75. One of the major cases for a PPP originally was that in the public sector NATS would not be able to get hold of the money needed to invest in new equipment, new capital and so on. I think Mr Everitt was saying that you were rather proud that your capital spending was 64 million last year.

(*Mr Everitt*) That is right.

76. What were you hoping to spend in a pre September 11 world?

(*Mr Everitt*) Not a great deal more than that. The big issue would have been the speed with which we could move on the Scottish centre. We had already made decisions prior to September 11 that we needed to review that project. As I explained to the Chairman, we have spent this year examining what our best options are and particularly how we can collaborate more closely with key partners in Europe. I think we are making good progress on that, so I would be surprised if it would have been a great deal more.

77. In paragraph two of this report on page one, the summary page, it says, "In 1997 NATS estimated that it required some £100 million of further capital investment every year for the next decade to increase air traffic control capacity to meet future traffic growth." Originally, back in 1997, you were looking for £100 million in capital investment a year and this year you are on half of that, are you?

(*Mr Everitt*) Yes. It is a broad order number obviously, £100 million a year. Part of my job is to make sure that we spend money wisely and effectively. We have taken this year to really work through what our best options are on the capital programme.

78. Could I ask you about one of those capital projects which I am sure you are very familiar with, which is the software system at West Drayton? Am I right in saying that this software was designed, if that is the right word, in 1975?

(*Mr Everitt*) One has to be careful. I think software is developed. "Written" is the right word. It is written in a language, as I understand it—I am not a technician—which dates from that time. It is our flight data processing and is a very similar system to that currently in use in the United States, so we are not alone in that.

79. It says in this report that you will be using elements of that software until 2011. Given the fact that it has completely crashed twice this year, have you brought forward plans to replace the software so that we do not have further crashes with possible catastrophic consequences?

(*Mr Everitt*) Firstly, the hardware is modern. It is the software where we have the issues and we have resolved satisfactorily now the issues that we experienced earlier on this year. Part of the capital plan is a sequential move away from the existing flight data processing that we have, but it will take time to do. This has been an extremely difficult issue for both our colleagues in America to address and for NATS itself to address, because the whole system is in effect driven by the software. We have a group of internal experts who understand it broadly and we bring in external advice on how we maintain it. Swanwick brought in a new dimension which I could go into, but I know time is limited, and we had to address that dimension which is basically sequencing the Swanwick software with the West Drayton software. We have learned a lot in the past nine months, but it does remain one of our vulnerabilities. This is a very complex system that we are trying to operate. The capital plan will address it but we will not finally be through dependence on that software probably until 2011–12. We will reduce it over time.

Angela Eagle

80. Mr Glicksman, I seem to recall when the Government first came to power in 1997 there was a left over from the previous Government and that was an assumption of a 500 million capital receipt for the sale of NATS which was put into the departmental totals. Is that true?

(*Mr Glicksman*) Yes, that is correct.

81. We also had the decision that we were going to operate within the previous expenditure totals as decided by the last Government. That is true, is it not?

(*Mr Glicksman*) Yes, that is correct.

82. There was a big hole in the expenditure or the income for the Department which necessitated raising moneys in order to fill the hole?

(*Mr Glicksman*) I am not sure I would describe it as a hole.

83. A lack of 500 million?

(*Mr Glicksman*) There was a requirement to reconcile the public expenditure plans that were inherited with the Government's plans.

84. That meant that there had to be an attempt to raise the money somehow, did it not?

(*Mr Glicksman*) It meant that some way needed to be found to reconcile the two plans, yes.

85. Which is the same as what I have just said, is it not? The only way that those plans could be reconciled was by gaining a capital receipt.

(*Mr Glicksman*) A capital receipt would have enabled the plans to be reconciled, yes.

[**Angela Eagle** *Cont*]

86. Ms Lomax, I know you were not there but would a not for profit solution have gained the capital receipt?

(*Ms Lomax*) I think so, yes. We could have got receipts for a not for profit company. That is made clear in the NAO Report on page 16.

87. When, in NAVCANADA, that option was looked at, it appears that that was discounted because it would not have taken any subsequent investment off the Government's books which is the Treasury rule.

(*Ms Lomax*) What it says here—and I have not seen anything to contradict it—is that the Department thought it would be difficult to ensure that NAVCANADA's particular structure would be classified as in the private sector so avoiding inclusion in public sector borrowing.

88. And yet we have seen from subsequent events we have a structure that is reasonably similar to some extent because the current arrangements are that there will not be any dividends paid. You said at the very beginning that, given hindsight, which is always useful to have, the arguments between having a PPP and a not for profit solution are now more finely balanced than they were. Is it the case that the Treasury rules should be looked at because they often lead you to making a particular decision which you might not have made had the Treasury rules been slightly different?

(*Ms Lomax*) It is not for me to comment on the Treasury rules but I think there were other reasons.

89. Mr Glicksman?

(*Mr Glicksman*) The rules are not the Treasury's. The classification rules are from the Office of National Statistics and the international rules the Office of National Statistics uses in deciding on the classification of public bodies.

90. We sign up to them for accountancy purposes?

(*Mr Glicksman*) For classification for the national accounts, yes, and statistical purposes in the case of the Office for National Statistics. The NAO report does not state that a not for profit solution would have been classified in the public sector.

91. It was thought it would not at the time.

(*Mr Glicksman*) As the report says, the definitive view would have been subject to a detailed assessment because it would have depended how exactly the body would have been structured.

92. Mr Everitt, you have decided not to distribute dividends. Is that right?

(*Mr Everitt*) We are not in a position to distribute dividends but the position of the Airline Group as shareholder is that they went into this on the basis that they would not seek a commercial return on their equity. At the end of the day, it will be for the board and the shareholders to decide on dividend distribution. There cannot be a prospect of that for some years.

93. How happy were you taking on a structure where the debt was so large that you had to borrow effectively the entire cost valuation of the business from banks, such a small amount of 65 million effectively was put into buy it, the rest was all in debt to the banks?

(*Mr Everitt*) I certainly looked at it. From a personal point of view I came into this job on completion of the PPP and looked at the testing that had been done against scenarios in the first two years and whilst it was clearly going to be tight it looked to be doable. The real change, of course, has been the unprecedented down turn since September 11.

94. The aim or one of the reasons for doing this right from the beginning was the 100 million a year of new investment that it was estimated the system needed to bring it up to the modern standards and keep investing in it. Is that going ahead as planned?

(*Mr Everitt*) I have already answered that. We did 64 last year and we will do just over 50 this year. We clearly have to tailor our short-term capital investment to the circumstances in which we find ourselves, that is one where cash has had to be conserved while we go through the restructuring of our finances, part of which is the application to the Civil Aviation Authority.

95. Do you anticipate you will be able to keep ahead of the game?

(*Mr Everitt*) In our business plan in two years we are planning to spend in excess of 100 million, yes. We will get back on track and I think we will be able to manage the risks much better.

96. Ms Lomax, this is a huge undertaking, where a lot of modelling was given, where huge amounts of work went in, where £44 million of Government money was spent on advice and a range of decisions had to be taken. Do you think on the whole that we have ended up with a better, more robust structure than we would have had if the sale had not happened and there had not been any restructuring?

(*Ms Lomax*) There have been some very significant benefits from the PPP, even in the very difficult circumstance it has had to live with. For example every other air traffic control body in Europe and North America has responded to the down turn since September 11 by raising prices, sometimes by very significant amounts. That has happened because they are subject to economic regulation, which is part of the PPP process, and that is a significant benefit. I think that the whole PPP process clarified and strengthened the safety framework in an important way. You can say, well that was not absolutely necessary, but actually the process of developing the PPP meant that issues were addressed, like the safety frame works, in a way which I think put NATS in a stronger position. Those are just two examples.

(*Mr Everitt*) We have also been able to attract new management, as it were, to complement the existing management, and that has been an important development.

97. You have their services for remuneration.

(*Mr Everitt*) One has to attract the right people and that has not been easy in the uncertainty we have been in, but it is critical for our future.

(*Ms Lomax*) The real proof of PPP will come in the longer term because what it was really about was providing a sustained flow of investment, which is something you can never be assured of in the public sector because there is always the risk of capital rationing in circumstances which are way beyond the concerns of individual public sector bodies. Over a period of time you ought to see a more sustained flow

[**Angela Eagle** *Cont*]

of investment into NATS and that will enable it to grow a culture in which people who are good at project management can make a future, so we will get a stronger project management culture throughout.

98. Given the constraints that NATS has in its structure, really its income is in the price it charges, are you comfortable with the fact that the regulatory system assumes downward pressure on prices?

(*Ms Lomax*) I think that NATS had the highest charges in Europe by some margin as far as I can make out. Even allowing for the greater complexity of the airspace over the south east of England NATS charges are pretty high. It was believed in the aviation sector that there was scope for genuine improvements in efficiency. I think NATS has been under pressure to manage the position in the way that it has and it is not necessarily an unhealthy matter. The Regulator's first duty is to have regard to safety. I think that we have a framework which safeguards safety but also puts serious pressure on NATS to be more efficient.

99. Mr Everitt, are you happy with that?

(*Mr Everitt*) Yes, I think the regime that we have asked for—which is the RPI-2 for each of the next three years with an indication that that sort of level will continue into the next five year period, which starts in '06—is a reasonable balance and will keep pressure on the business for efficiency. I think that is what our airline customers expect, indeed they hold us out as the model. If you talk to IATA or any of the representative groups this is the way they want to see air traffic control in Europe go. As the Permanent Secretary said we reduced our charges last January and we will reduce them this coming January. Very few major suppliers in Europe have done that. The average increase last year in Europe, last January, was 12% in a very depressed aviation scene.

Geraint Davies

100. On that last point, Mr Everitt, am I right to say all of the prices went up just before NATS was sold off? I am right, am I not? The charges to airlines from NATS increased before the transaction occurred?

(*Mr Everitt*) I have no idea. Not that I am aware of. I do not think so.

101. Perhaps we can have a note on that to confirm that is the case.[3] Can I ask Treasury, on the value of the sale we have been bandied round this figure of £800 million, am I right to say that in addition to that the Government had to pay off some of the existing debts of NATS, £300 million?

(*Mr Glicksman*) Some of that £800 million was used to pay off NATS debts.

102. The net received was £500 million.

(*Mr Glicksman*) Roughly that sort of figure after paying off the debt.

103. On the assumption it was £800 million, the NAO suggest that as well.

(*Ms Lomax*) The Government's cash proceeds were £758 million, as stated in the NAO Report.

(*Mr Glicksman*) Some of which was used to pay off the debt.

(*Ms Lomax*) It is a clear answer, there is a very good table in the NATS—

104. Can we have a note on that as well?

(*Ms Lomax*) There is no need for a note, if I may respectfully suggest, it is all set out very clearly in the NAO Report in Table 20, page 37.

105. Perhaps the Treasury can advise how much debt was paid off?

(*Ms Lomax*) £700 million of Government debt was paid off, £330 was National Loan Fund debts, which was quite old.

(*Mr Glicksman*) £330 million was paid off.

106. We paid off a bit of our debt, then we got the funding. Moving on, if I may, may I ask, in terms of the way the competitive bid was managed, particularly in terms of the Airline Group and Serco (Nimbus), given that the Airline Group fly planes and NATS were in the same market, and therefore subject to the same risk if there was a down turn due to Gulf War, or whatever it is was that factored in against the Nimbus bid, what I mean is, all things being equal, one would have thought one would go for the Nimbus and Serco to spread one's risk?

(*Ms Lomax*) I am not sure how much risk spreading you would have got because Serco are also involved in this sector as well. If you are talking about a totally major impact on the aviation sector there was a provision in NATS' licence, as I think I mentioned a few minutes ago, for an exceptional price review.

107. You mentioned that the world looks like a riskier place since September 11, if this deal were going through now, given we all know it is a riskier world we live in, how much less than 800 million would you think it was reasonable to take from the preferred bidder?

(*Ms Lomax*) I cannot answer that question. I think that probably the structure of the deal would have been a little bit different. I think that the work that is going into the big announcement at the moment as a composite solution is a reflection of the need to adjust to the world as it is now.

108. Can I ask something about delays. My understanding is that the level of delays prior to September 11 in Britain was similar in France, Germany and Spain but since September 11 they have reduced their delays because there has been less traffic and they are taking the opportunity to reduce delays, however our delays have increased. Why is that?

(*Mr Everitt*) There are a number of reasons, I think. One is they have had the benefit of increased capacity through something called RVSM, which is vertical separation.

109. Is it because they have a public sector remit and we have this narrow financial remit for NATS?

(*Mr Everitt*) We have brought on this major centre at Swanwick which is a huge technical challenge. I have been on the record publicly saying we did not have enough controllers, we were some 30 to 40 controllers short, we have addressed that issue. In our memorandum you will see how we have progressed from the early summer.

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[3] Ev 28.

[**Geraint Davies** *Cont*]

110. Is this a coincidence that after September 11 there is less traffic and in Britain we do a lot worse and it is nothing to do with PPP. Is that correct?

(*Mr Everitt*) It is nothing to do with PPP, it is to do with the fact that we brought Swanwick on.

111. You mentioned the issue of trained operators there, am I right in saying that given there is a lot of financial pressure on NATS it is true, is it not, that therefore you are shortening job training and assuming a higher level of pass rate for trained operators in order to hit your targets for the number of operators you have. Firstly, can you confirm that is true? Do you think there is a question mark over quality and, therefore, safety?

(*Mr Everitt*) We have an independent regulator who will make sure we reach the right quality level. We have not shortened training. We have certainly set challenges to improve the pass rate, the pass rate is wholly unacceptable.

112. You have not shortened job training? I understood from the Report that that was the case, from the NAO brief that members were given. Maybe we could have a note on that as a point of fact.[4]

(*Mr Everitt*) The training has to satisfy the CAA.

113. 3.12, page 35 "shorten the period of on-the-job training". Four lines from the bottom, the period of on-the-job training has been shortened.

(*Mr Everitt*) We, "hope to achieve significantly higher pass rates by more selective recruitment and effective training and shorten the period of on-the-job training". It is a hope. It is an aspiration. This is what happened in the airlines over many years.

114. Will you be spending more or less on training?

(*Mr Everitt*) We currently spend 23 to 25 million a year on training. I want to get more out of that money, like more people where I need them.

115. May I ask, this is a tricky issue, on the Treasury rules that have been mentioned, there was this issue about where the public sector comparator is, obviously the public sector comparator presumably was the previous NATS, because we had something in operation. The question was, how do we get more money into the system for new investment, 1 billion as promised for PPP—we have not yet seen that—am I right to say if we had done that through a bond issue that that would not have counted towards PSBR according to the OECD definition in the Maastricht Treaty? If that is the case is it just Britain and the British Treasury who have perverse definitions that stop us putting bond money into the public sector?

(*Ms Lomax*) You take me outside my field of expertise.

(*Mr Glicksman*) I am not familiar with the Maastricht Treaty.

116. You have not read the Maastricht Treaty! You must be conversant with the conventions on public sector borrowing requirements in our European partners, which happens to be the one in the Maastricht Treaty, which is that bond financing in this public service would not count. That is correct, is it not?

(*Mr Glicksman*) I think we comply with the international conventions on the classification of expenditure.

117. I am sure you do.

(*Mr Glicksman*) I think the question is, what are the figures that are controlled rather than whether they are in the public sector or not?

118. Is it not the case in terms of definitions and how we apply them that we have allowed a bit more flexibility in the terms of the Channel Tunnel rail link and United Kingdom regional airports?

(*Ms Lomax*) We have in the case of the regional airports, that is correct, but not on anything like the scale that would be necessary for NATS purposes.

119. May I ask, there are clearly difficult financial conditions, there is very high gearing, as has been made clear by Mr Williams, we also have a situation of massive technological uncertainty in the market by taking big risks on that, if it is necessary to offer greater financial assistance would we be asking the government for more money to put in if we had a situation akin to the West Coast Mainline Project? We do not know what the future holds, in the event that the market will not deliver the money I presume we will ask Treasury to bail out the system, is that right?

(*Mr Everitt*) The first big tranche of capital investment, technically the most challenging one, has been Swanwick, which we bought in in January. Our objective is to renew most of the system over the next ten years. We think we can do that within the sort of figures that we have just been talking about. Part of our job as a management team is to manage that risk effectively.

120. I know. If things end up costing more and the revenue is less than business assumptions and the private sector will not stump up the money what are you going to do, are you prepared for there to be some retrenchment of services or a question mark over some operational investment that underpins safety?

(*Mr Everitt*) You are asking me to deal with a hypothetical. The responsibility that we have as a management team and as a board is to manage our way through these technically demanding projects, and they are technically demanding. The biggest one we have now brought home, which is Swanwick.

121. Do you think there is a case for night time radar investment over Edinburgh Airport, there is not yet the traffic. Do you agree if there was a big constraint on finances that that sort of project that would improve safety would not be done. It may not be done anyway.

(*Mr Everitt*) I would need to consider that. I do not know the circumstances about night time radar in Edinburgh.[5]

Mr Howarth

122. Ms Lomax, one of the Government's aims for the PPP was to improve management expertise in NATS and when you were answering the chairman's questions at the beginning of the session you made

[4] Ev 28.

[5] Ev 29.

[**Mr Howarth** *Cont*]
two points which I thought were useful in terms of giving some indication of how these things were measured. The first one is that you said one of the aims was to achieve a stronger commercial framework. I think rather than one answer perhaps over a number of answers you have given some clues to that. The second one was to improve greater efficiency. It would be helpful before I go any further if you could define for me what you mean by stronger commercial framework and if could you define what you mean by efficiency in this particular context?

(*Ms Lomax*) I was quoting when I used the words "stronger" and "commercial framework" from a memorandum Treasury sent to the Transport Select Committee in 1998, explaining why we were going for the PPP rather than the not for profit solution. I am not sure it is necessarily a word that I would use myself. What do I mean by greater efficiency—

123. I did not ask you to tell me where you were quoting from I asked you what you thought it meant in this context?

(*Ms Lomax*) I think it means an organisation which uses the resources at its disposal more effectively and more efficiently in perhaps some of the ways that Mr Everitt has been talking about this afternoon, that does not necessarily have the highest charges in Europe, for example.

124. That does not explain the commercial part of it at the time, does it? The definition you have given could apply to any organisation.

(*Ms Lomax*) Yes.

125. What was distinctive about this particular one?

(*Ms Lomax*) Commercial pressures come from the scrutiny of the strategic partner and the banks providing a demanding financial framework within which NATS' performance is assessed. For example the business plan is much more widely discussed now than it was in the public sector, people are scrutinising NATS' performance in a demanding sort of way and their ability to attract finance and maintain a good credit rating will depend on their performance. That, I think, is the sort of thing I had in mind when I was talking about strong commercial framework. Those sorts of disciplines come from seeking private finance in the financial market, it is very different from operating in a political competition for finance within the public sector.

126. You went on to talk about greater efficiency, it seems an obvious question and sometimes the answer does not line up with the question, what did you mean by greater efficiency? How would you measure that?

(*Ms Lomax*) There are a number of different ways of measuring efficiency. At the moment two thirds of the 5,800 people in NATS are not air traffic controllers.

(*Mr Everitt*) We employ just under 2,000 people who are air traffic controllers, of which 1,400 are active, the others are in training.

(*Ms Lomax*) No doubt eventually over a period of time the Airline Group certainly seem to envisage working towards an organisation which basically has more of the resources put into the frontline operation. That would be one way which it might make it more efficient.

127. Any others?

(*Ms Lomax*) I will ask Mr Everitt.

128. I will be interested in what Mr Everitt has to say however it was you who used the phrases and I was trying to test out what you meant by them.

(*Ms Lomax*) I was talking about the framework within which NATS was operating and the sort of scrutiny they were subjected to and the sorts of things that people would look at when they would decide whether NATS was performing well. They would certainly be looking at things like whether NATS brought on projects in on time and on budget and got benefits from them. That is what investors were looking for and it is something which it has not been successful at in the past.

129. Are you going to give greater clarity than that, Mr Everitt?

(*Mr Everitt*) Commercially, as the Permanent Secretary said, the accountability, particularly to the capital markets for the money that we seek and, indeed, to our shareholders is one way. I think we are highly accountable for our performance now, not only to those capital markets but much more widely. We have independent regulators in a way we did not have before, we have economic regulators, we have safety regulators and stakeholder councils, so there is very high accountability. That is part of commercialism. I also think we now have an opportunity to take some of our skills and expertise outside the company and seek to earn from those. We are doing that in a measured way, because these are not easy markets to get into, but I would expect over time we will make good progress in that area too. Procurement is another area. We have spent a lot of time this year improving our procurement arrangements. We have also brought much greater efficiencies in the way that we transact our human resources, our facilities management, we brought all those into single organisations rather than having them scattered all over the business. There is a host of things we are striving to achieve to get greater efficiency, which means greater return for each pound we have available to us. That is really the way I would characterise it.

130. I understand that you are in process of, you might have already introduced it, an executive bonus scheme?

(*Mr Everitt*) Indeed.

131. Can you tell me, against all of those criteria you have just suggested in relation to efficiency how each person's performance is measured against those?

(*Mr Everitt*) Yes. We now have a bonus scheme for part of our senior management. They are rated in a number of areas, the overall safety performance of the business is number one, quite clearly. They have personal targets. We have financial targets in at least three of the four criteria that we use. Each year we assess their performance against their individual performance and obviously we assess where we are in relation to the overall group performance and then appropriate bonuses are determined. There will not be a single bonus for everybody or a single percentage for everybody, it will range according to how people perform.

[**Mr Howarth** *Cont*]

132. Is it possible that the organisation could be performing in financial terms badly but people could still be gaining additional rewards through the bonus scheme?

(*Mr Everitt*) It would be right to say in the public sector that was a possibility. What we have done is introduced a bonus scheme which has an ability to pay element in it. One of the issues we face this year was that people had contractual entitlements to bonuses which was a carry over as the PPP came in. We changed that this year so that there is now an ability to pay element in the bonus.

133. In other words if the organisation was performing badly it would follow that in some elements of that scheme nobody would qualify for it?

(*Mr Everitt*) Yes. Part of the decision I had to make this year in relation to the contractual bonuses was how much we would be prepared to pay.

134. Thank you. Can I come back to Ms Lomax, we left Mr Williams' line of questioning slightly unresolved and I ended up quite confused anyway. I think the point he was driving at, if I understood him correctly, was when you were determining the cost involved, whether or not viability was taken into account, the point he was making is—let me explain it, many, many years ago in my youth I was a member of the local authority and I remember that in the tendering procedure if you got an exceptionally low bid for a particular project it would have to be scrutinised very carefully just to make sure they were capable of delivering what they said in the price available. The concern we have about the difference between what was estimated as likely to be going through the transfer and what was bid was that maybe there was a problem of that kind that had not been taken into account. Have I made myself clear?

(*Ms Lomax*) The test for financial credibility capacity was not properly executed, is that your point?

135. It was not clear in the answers you gave earlier that was the case, no.

(*Ms Lomax*) There was extensive testing of all of these bids against a range of financial criteria, yes, it was a long and very technical exercise and that was part of what the advisers were doing. I cannot now remember exactly what point Mr Williams was talking about. What I was trying to say in answer to somebody else was that the decision that was taken about which was the best bid took account of all of the evaluation criteria, it was not just the proceeds, it was not just the financial credibility capacity. it was a decision taken in the round.

Chairman: Thank you, Mr Howarth.

Mr Jenkins

136. You paid some substantial costs to advisers and yet I noticed on page 24 you have the cost of implementing a partnership and the estimate for implementing the partnership and out turn quite at variant, who advises on the estimates?

(*Ms Lomax*) I think that the original estimates were based on, it says in footnote one, the estimate was set in August 1999 using estimates provided by the advisers, NATS and the CAA.

137. Who were the advisers, just NATS and the CAA?

(*Ms Lomax*) The advisers estimated how much work they thought would be required. NATS and the CAA based its initial estimates on those views.

138. I thought if the advisers were advising you with the estimate and it turned out in some cases they were substantially different, the legal advice went three times the out turn against the estimate, do you feel you had the right advice in place?

(*Ms Lomax*) The original cost estimates were clearly optimistic. I think the Department took account of what information and advice was available not just from the advisers themselves but from NATS and the CAA and its own experience too of previous operations. What was clearly the case is this was a much lengthier process and a more complex process than people understood when those original estimates were set.

139. One of the things which Mr Williams started off with, I am still struggling here, I must be honest, if I read it correctly, I obviously do not, because I do not understand these systems, we sold half a company in effect which was worth quite a substantial amount of money and when we sold the company the purchaser put a very small amount of funding into that and then borrowed the rest from the bank. The debt was not on them but the debt becomes that of the company. I own half the company, so I presume it must be my debt as well then?

(*Ms Lomax*) I do not think this is a completely unconventional way of making an acquisition. I think this happens quite commonly and you always put debt into the acquired company, you put as much debt on you think it can bear given the amount of income it is likely to generate. The more debt you put into it the less there is going to be available for splitting out between the equity shareholders. The general view for regulated utilities I think is that making large profits for the equity shareholder is not a good thing.

140. I have the debt of the company that I once owned and I got half the money in the bank, so now I have 49% of the company, this cannot be right, nobody would buy this one, so all of the profit in future years, and I use that term advisedly, is going to go to the bank, obviously. I am going to sit back and watch that debt be financed over the next number of years without any income coming to me. Am I right?

(*Mr Everitt*) That I think is correct. In other words the bank have the first call on the money in the business to service that debt. It was a very clear policy of the Airline Group that we would use the remainder to contribute to the capital expenditure of the business. It would certainly be the case in the initial years.

141. At the end of the day I am the 49% owner of this company and what would be profit to me is not going to come to me because it is going to be paid to pay off the debt of my partner who borrowed the money, so I am going to pay for it, am I not?

(*Ms Lomax*) You managed to get £758 million in proceeds to compensate you in the beginning.

[**Mr Jenkins** *Cont*]

142. You sold it for £700 million.

(*Ms Lomax*) The value of NATS at the time, at the risk of confusing this any more, the total value of the business at the time of the sale was estimated to be rather higher than £758 million, something like £873 million, the difference between the £758 and the £873 being the value of the equity is the way I have looked at it.

143. In effect the business had gone.

(*Ms Lomax*) No.

144. There would never be a return from this business, anybody who thinks so would be in cloud cuckoo land.

(*Ms Lomax*) I do not think anybody thought of NATS as a profit generator, it was supposed to be a better deal for NATS as a business. All of the debate about it and the structure of the PPPs was about providing a better framework for NATS to provide air traffic control services not as a profit generator for the government or the Airline Group.

145. I thought I had seen something in one of the charts, one of the criteria used to depict this scheme, page 15, was providing a return to the taxpayer, you know that poor sucker out there.

(*Ms Lomax*) Yes.

146. Proceeds from 46% of the sale and future dividends. Somebody must have thought there was future dividends somewhere.

(*Ms Lomax*) The legislation does allow the PPP to pay dividends, it is just that the Airline Group put in its bid on the basis that it would not be looking for future dividends.

147. Of course it will not be looking at future dividends, that is the main benefitor from the fact we can keep the price down low, we are not transferring money from them into dividends and half of which will go back to the taxpayer. You would not have that deal?

(*Ms Lomax*) I am not sure I follow you.

148. If you have a company running and it makes a small amount of profit, 49% goes back to the 49% tax holder and 49% goes back to the Airline Group, now the only place that profit can be generated is in the charges to the airline companies. Am I right? If they make a profit on the airline companies, 49% of which is going to go back to the partner, they are going to be at a disadvantage and what they want to do is take up that profit totally, no profit, and therefore 49% will not go back to the partner, but the costs on them as the consumers will be less. Am I right?

(*Ms Lomax*) I think the impact on them as consumers—I am not sure I am entirely with you—the body that will determine the charges to consumers, to airlines, is the CAA through its economic regulation division. It is the economic regulator that sets the prices. I do not think the Airline Group has the ability to manipulate the business in NATS to its own advantage. There are various safeguards in the structure of the PPP to make sure that NATS is not run for the benefit of the Airline Group in the way that you seem to be implying.

(*Mr Everitt*) I also think it is critical we make profits in order to invest. We have to make profits in order to invest because that is the only way we are going to attract the income.

149. That is just money going back in, reinvestment in the company.

(*Mr Everitt*) Surplus being reinvested.

150. The bank get their surplus, the management get a bonus because they are now creating surpluses, what does the taxpayer get?

(*Mr Everitt*) When dividends are ultimately paid they will get 49% of the dividends.

151. Would you like to estimate what year that would be, please?

(*Mr Everitt*) What has gone on here economically is that the taxpayer has taken a very sizable sum, in other words in lieu of certainly dividends over the next few years. That is really what has gone on here.

152. When you go to the bank for any working capital, like you did last year, you turn up to the Government, you went to the Government because the bank said they would give you no more.

(*Mr Everitt*) We were in a period where we had not settled with the Civil Aviation Authority and the Civil Aviation Authority were considering our application for price adjustments. This was a temporary facility, hence it ran out in September, to tide us over a period to enable the CAA to make a decision. It has taken longer to get the CAA decision but we have not had to call on that money. It is not a precedent for the future.

153. You are being sent notes that are quicker than your answers at the moment. When you look at any company, and if you look at this one in particular, you realise because of the viable nature of it as an entity you can load some debt on to a company but at one point the bank say "no more". How close would you be to that point where the bank say no more? How much debt would you have to have before this company becomes non-viable and you will you have to move to put it into administration? Have you worked out a scenario? Have you got an exit route mapped out?

(*Ms Lomax*) The CAA has made it clear that it thinks that an appropriate financial structure for NATS in the current circumstances, given the risks as we now see them post September 11, has less debt than it had at the time the PPP was concluded. That is part of what the financial restructuring is achieving. Both the government and the new shareholder will put in some more equity to reduce the amount of bank borrowing levels. That is the essence of the composite agreement that is being discussed at the moment. The details on it are not finalised but at the moment that is where we are.

154. Do not tell me that our partners are going to borrow this money off the banks and incur a further debt on the company, they are going to put in cash, are they?

(*Ms Lomax*) This is a conversation that is going on between NATS and the CAA, I do not want to anticipate a deal which has not yet been done.

Chairman: You are going to have to leave it there.

Mr Davidson

155. Can I ask Mr Everitt, if I heard you correctly you mentioned that the airlines were going to have a 12% reduction in charges.

(*Mr Everitt*) The average increase in Europe this calender year was 12%, that took effect last April. We went down 1.5%.

156. That is a 13.5% difference had we been following. I am not clear in terms of the scale of this how much you receive in income overall from airlines?

(*Mr Everitt*) Our total income is just under £500 million a year from airlines in the en route business and another £80 million or so in the airports business.

157. Leaving aside 13.5%, that is too complicated. If I took 10% of that it is £50 million that airlines would have saved by your charges not having gone up, considering a consortium of airlines paid round about 50 million for a share in yourselves they have effectively got most of the money back in 15 months or so?

(*Mr Everitt*) They are about 25% of our costs. They pay about 25% of our charges.

158. The reduced charges they are paying is in effect a shareholder dividend for them and they have got a substantial percentage of their money back already.

(*Mr Everitt*) I think there are very few airlines that would see it quite that way. They have clearly lost significant sums of money in the past 12 months, certainly the major carriers have obviously tremendous difficulties.

159. In terms of those that put in the 50 odd million to yourselves they have had a substantial proportion of that back already in reduced charges?

(*Mr Everitt*) I think it is difficult to characterise it in that way because whether they invested in us or not they would still—

160. That is how I see it, I must say. Ms Lomax, if we are having this restructuring which is going to have a reduction of the percentage of debt and an increase in the percentage of capital, presumably that will mean the Government putting back in some of the money it got out from the sale?

(*Ms Lomax*) We have already made it clear, and it is in the NAO Report, that the Government, as a responsible shareholder, will match the contribution of another equity shareholder, yes.

161. That is a yes to the question I asked?

(*Ms Lomax*) We will not go beyond that.

162. Can I turn to Mr Everitt then, as I understood it you said earlier on for the last 15 months capital investment had been funded by the cashflow of the business itself. In those circumstances I find if difficult to see where the gain has come from this partial privatisation since presumably if you are capable of financing your investment by your cashflow, because the bank are refusing to give you any more money, you could have done it without this creation of debt and all of the rest of it? If you did not have the interest on the debt you would have a greater cashflow free for investment. Does that seem a fair way of looking at it?

(*Mr Everitt*) That is a way of looking at it. The way I have looked at it is that we have needed to conserve cash in the business. As I set out earlier, my criteria were that safety was paramount, et cetera. What we will need is access to additional capital as we move into more significant projects.

163. As of now you are funding your capital investment from cashflow and therefore the whole process of privatisation has made not one jot to your ability up to now to reinvest because it does not seem to have made any difference. Indeed it has made your position worse since you had not had this high interest capital debt on your backs then you would have had more free cashflow in order to plough into your investment?

(*Mr Everitt*) I have had to deal with the situation that I have had, that was clearly that we do have the debt in the business. What privatisation has brought to it is a number of things we outlined, not least charges to the customer going down in very difficult circumstances.

164. I may come back to that if I have time in a moment. I take it that the cost of borrowing from Government would have been less than the cost of the borrowings that the Airline Group undertook. This is to Mr Everitt, can you give us an indication of by how much more the debt was costing and is costing in interest terms?

(*Ms Lomax*) In general terms Government can usually borrow significantly cheaper than anybody else. I do not know what the expected margin will be.

(*Mr Glicksman*) It varies.

165. In terms of looking at what the Government got back in terms of 750 odd million, 1% difference of that would have been in terms of interest payments, how much are we talking about as a saving?

(*Mr Everitt*) About half a million.

166. £50 million this year!

(*Ms Lomax*) Half a million.

167. Half a million.

(*Mr Everitt*) A bit more, £7 million.

168. It has been suggested to me in terms of the cost of management comparing like with like in terms of the position now and the position before the cost of the upper range of management has gone up by 70% since the PPP was introduced. Can you confirm that is correct?

(*Mr Everitt*) I do not have that number at my fingertips. I am looking at our Annual Report. There has certainly been some increase but I cannot confirm that number.

169. Round about 70%?

(*Mr Everitt*) I do not know, I would have to check that.[6]

170. I find it surprising that you do not have it at your fingertips, an indication of how much the management cost has gone up. If it is 70% that is a surprising figure, after all we are not talking firemen here. I would have thought that we had some explanation of that. Can I ask about the cost of advisers and whether or not Ms Lomax in the

[6] Ev 29–30.

[**Mr Davidson** *Cont*]

circumstances did you think that the cost of advisers was actually good value for money. I did come across a table in here on page 24 where the costs of advisers for this privatisation is greater than the cost of advisers for the privatisation of the rolling stock companies, Railfreight Distribution, Scottish Buses, HMSO, LT Bus Companies, Royal Ordnance and National Transcom put together. In these circumstances do you not think you were taken for a bit of a ride by the way in which you struck the deal with your advisers, whereby they were being paid irrespective of whether they did any work.

(*Ms Lomax*) That is the way these people are customarily remunerated. I think a large, highly complex, highly controversial deal like this is not one to buy advice on price. You want the best advice you possibly can when you are dealing with such a large, sensitive and important business.

171. Given size and given the percentage of the pay compared to the cost of the advisers it is a much, much higher percentage than in almost any other privatisation. Is this just so much more complex than any other privatisation to justify these fees?

(*Ms Lomax*) I quote back to you what the NAO says, "as each deal is different any comparisons have to be treated with care. As a proportion of the value of the assets sold the transaction costs are higher than average but not evidently unreasonably so given the need in this case to negotiate an on-going PPP as opposed to a more straight forward trade sale."

172. I find it very interesting that at the beginning you mentioned there was no public sector comparator for this privatisation, were you aware that members of Parliament were told this was not a privatisation?

(*Ms Lomax*) I did not say it was a privatisation. I said, in privatisations there was not one.

173. Why did you make that comparison?

(*Ms Lomax*) It was a partial share sale.

174. What is that, a partial privatisation?

(*Ms Lomax*) Yes, it is a partial privatisation, is it not, but of a particular and innovative kind which safeguards the concerns that members on both sides expressed very strongly.

175. Can you clarify why the Department while this process was being undertaken was telling members of parliament it was not a privatisation?

(*Ms Lomax*) It is not a simple privatisation, it is a public private partnership.

176. It is not privatisation then?

(*Ms Lomax*) It is not the same as a privatisation, no. The idea of a public sector comparator is of relevance, I suggest, in situations where there is not a policy decision to do it, as there was in privatisation. This reflected a policy decision to sell off some of the shares in NATS, to sell equity interest and to seek a strategic partner for NATS. It went through the House of Commons and it was extensively debated. It is not something that was a sort of value-for-money decision by a civil servant.

177. I think my point has been made.

Chairman

178. We are going to have to read the transcript, I thought you said in answer to questioning from Alan Williams you were saying something along the lines of we do not have public sector comparisons in privatisation.

(*Ms Lomax*) Would it be helpful if I clarified what I tried to say because one does not always say absolutely what one means the first time round. I was trying to say that public sector comparators are not the invariable rule, we do them for PFI projects but we do not do them for privatisations, where there is a much greater degree of political involvement, including in the House of Commons. With a PFI deal, it would not go through the House of Commons, it would not be such a political issue, it would be a value-for-money decision. As accounting officer, I would need to satisfy myself that it was good value for money. NATS was much more in the political arena of policy decision.

179. Was that yes or no?

(*Ms Lomax*) I do not know what the question was.

Chairman

180. We will have to leave it there.

(*Ms Lomax*) I would like to clarify at the end the confusion I caused over Figure 21.

181. We will come back to that.

(*Mr Everitt*) Can I just mention that the cost of the board has gone up from £684,000 to £770,000 from 2001–02, I calculate that as 12.5%. At that time we had taken on three government directors as well. I think there were reasons for it.

182. Can I clarify whether or not that is a like for like comparison in terms of senior management?

(*Mr Everitt*) I am simply taking the costs in our accounts of the board remuneration to directors in total, non-executive as well as executive, for 2001–02.

Chairman: That is not an answer to the point. I wonder if we can have a note clarifying what the comparison like to like for senior management is. It is my understanding it is a 70% increase. If that is not the case I would be grateful to have that clarified.[7]

Mr Bacon

183. I have a copy of the report accounts and the page concerning the directors salaries, it is not particularly clear so if you can give us a note setting out all of remuneration for non-executives and executives for the period prior and after the part privatisation that would be very helpful.[8] It appears there were three executive directors getting round £230,000. Tell me, given that your controllers had to go on strike to get their pay rise, asking Government for more money, do you think the pay rise and bonuses were excessive?

(*Mr Everitt*) My personal pay was settled at the time I joined the company.

184. I was not just talking about you, I was talking about everybody.

[7] Ev 29–30.

[8] Ev 29–30, 32–33.

[**Mr Bacon** *Cont*]

(*Mr Everitt*) So far as the second director is concerned, that contains an exceptional bonus which was paid and agreed prior to PPP and which triggered on the opening of Swanwick.

185. This was the £62,000 to Mr Chisholm?

(*Mr Everitt*) Part of the £62,000 was his general bonus and the second part, the £39,000, related to Swanwick.

186. Given what has happened, do you think these payments were excessive?

(*Mr Everitt*) The payment was contractual.

187. I did not ask about its legal status. I asked whether you thought this was excessive.

(*Mr Everitt*) It was certainly justified against the fact that he took hold of this project three years before.

188. If you could put it in the note. I certainly would have expected it to be legal. I was asking what your personal opinion was of them. If you could let us have a note on that, that would be very helpful.[9] What is your current situation so far as shortage of controllers is concerned? How many are you short now?

(*Mr Everitt*) In Swanwick we are now in the winter season so we would not normally open as many sectors as we would in the summer. Our plans are focused on next summer and a considerable amount of work is going into the planning for next summer. On our current estimates we would think that we could be up to 12 controllers short for next summer, but we are working on that and our plan is not settled.

189. My question is about now, what are you at now?

(*Mr Everitt*) From the summer we were 40 short.

190. Could you say that again?

(*Mr Everitt*) Between 30 and 40 short this summer.

191. And right now?

(*Mr Everitt*) I do not have the precise number as of this moment.

192. Could you send us a note showing how it has changed in the past and what you are anticipating in the future?[10]

(*Mr Everitt*) Sure.

193. How many days have you bought back?

(*Mr Everitt*) You mean in terms of the deal that we did we controllers for voluntary attendance?

194. Yes, how many days?

(*Mr Everitt*) I could give you a note on that.[11] Very few so far, they would mainly be for summer next year.

195. How many days off are controllers owed?

(*Mr Everitt*) As part of the pay deal we are buying out their days off.

196. I was not asking you that, with respect.

(*Mr Everitt*) I have not got the number at my fingertips.

197. I would like to know how many days off controllers are owed. If you cannot answer the question now could you not answer a different question I did not ask but just save us time and send us a note.[12] I do not have a lot of time and it is just annoying when I get an answer that is not an answer to the question I asked. Could you say what has been the increase in overload reports?

(*Mr Everitt*) I can give you a precise number on that but, again, I would want to give you a note.[13] There has certainly been an increase but that has apparently been a consequence of Swanwick coming into operation.

198. Are you familiar with the form that controllers fill in when they have a report?

(*Mr Everitt*) Yes, a 1261.

199. Is it correct that the form has been changed so that it no longer has to be countersigned by the watch manager and supervisor?

(*Mr Everitt*) That I do not know, I would have to check.

200. Again if you could let us have a note.[14] I understand it did used to have a section underneath where the watch manager or supervisor had to agree or not agree with the comment logged by the controller. I am told this section has now been removed and I would like to know if that is the case or not.

(*Mr Everitt*) I would have to check.

201. Your approval under Article 88 of the Navigation Orders; is it permanent or temporary?

(*Mr Everitt*) I think it is an indefinite approval.

202. You think it is?

(*Mr Everitt*) Yes.

203. What about when it was first given in January, was it permanent or temporary?

(*Mr Everitt*) Indeed it was—I will need to check that but my understanding—

204. There is a letter to you from Mr Dancer, the head of Air Traffic Safety Standards Department from 22 January in which he tells you that your Article 88 Air Navigation Order approval has again been time-limited. It cannot be indefinite and time-limited at the same time, can it?

(*Mr Everitt*) I would need to check that.

205. Which is it now? Indefinite?

(*Mr Everitt*) My understanding is that it is indefinite but I would need to check.[15]

Chairman

206. You seem to have to check a lot of things. You run this thing.

(*Mr Everitt*) I did not come prepared for operational questions, I thought we were talking about the NAO Report.

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[9] Ev 29–30.
[10] Ev 30, 33–34.
[11] Ev 30, 34.
[12] Ev 30–31, 34.
[13] Ev 30.
[14] Ev 31.
[15] Ev 31, 34–35.

Mr Bacon

207. I am curious because the Health and Safety Executive on 18 January, four days before you opened, said there were concerns about safety in relation to the centre and what it called "design deficiencies" which may have implications in relation to air safety and that as a result of that, presumably, that was why you were given a time-limited approval?

(*Mr Everitt*) No.

208. That is not the case?

(*Mr Everitt*) I do not think that is the case at all. We were given checks before we opened Swanwick and the safety regulator was perfectly content that Swanwick met all aviation safety requirements and the health and safety issues were around the possible effects on people at work, as it were; they were not air safety issues.

209. Is it a matter of the regulator's opinion or is it a question of what the law says?

(*Mr Everitt*) The aviation safety regulator clearly has to make judgments, as most regulators would have to in these circumstances, and those were the CAA's judgments.

210. What I want to know is if your contempt was okay, why did your approval say, and I have got a copy of it here: "This approval is effective from 26 January 2002 to 26 July 2002, unless revoked, varied or suspended", and why was it given this time-limited condition?

(*Mr Everitt*) Can I just check for one moment. Could I give you a note on that rather than speculate.[16]

211. You have been telling me in your first answers that the approval was indefinite.

(*Mr Everitt*) That is my understanding.

212. This is a fairly fundamental thing, whether you can operate or not. It says here: "Air Navigation Order Article 88, approval for the provision of air traffic services." That is what you do, is it not?

(*Mr Everitt*) Indeed.

213. So this is the right piece of paper I have got. You have approval here subject to the conditions stated in the schedule and it has got a date on it and it says effective to 26 July. In your first answer to me on this subject you were saying it is indefinite. It plainly is not indefinite, is it?

(*Mr Everitt*) My understanding relates to the current approval we have. We have approval to operate an air traffic service as issued by the regulator.

214. I hope you do. My question was whether it is a permanent approval.

(*Mr Everitt*) Could I give you a note on that.[17]

215. Yes please, fine. I want to ask you about height capping. I understand this is a standard procedure in the industry. How much has height capping increased since Swanwick opened?

(*Mr Everitt*) I can give you a percentage but obviously, as we have boarded in and dealt with the situation this summer, there has been an increase in height capping, yes, and that has been part of the management of the system as we have worked through the opening of Swanwick.

216. Could you give me a note—and perhaps you can answer it now and if you can that would be great—on how many journeys there have been which have been height capped since Swanwick opened?[18]

(*Mr Everitt*) I think that would be difficult but I will do my best.

217. And also over the last three years at West Drayton prior to Swanwick opening how many journeys were height capped?

(*Mr Everitt*) I will do the best I can but we obviously do not measure each one.

Mr Bacon: No further questions.

Chairman

218. Could you give us a note on the interest paid on each of the years since the start of PPP?[19]

(*Mr Everitt*) Certainly, very easily.

219. This retainer paid to CSFB; was it good value to pay them a monthly retainer irrespective of the work that they did?

(*Ms Lomax*) We think so, yes. They did a lot of work

220. But was it good idea to pay them a monthly retainer irrespective of the amount of work that they did?

(*Ms Lomax*) That is the way they are normally remunerated by their clients and they are not alone; most similar firms operate on exactly the same basis. Lawyers do not and that is why we dealt with Slaughter & May differently.

221. Let's not get involved with lawyers. Is it fair to regard NATS as a utility like water. Surely it is inherently riskier and therefore unsuitable for RPI-X or minus regulation? It is inherently riskier, is it not?

(*Ms Lomax*) It looks that way. How risky it is depends on how the regulator himself behaves. I think it is difficult to say how risky a utility is in the absence of clearly stated regulatory policy and that is only now being agreed.

222. Let us get back to this question of paragraph 3.27. If you turn to that on page 39 it deals with figure 21 on which there was debate earlier. You will see at the end of paragraph 3.27 it says, "given a reduction in traffic on the scale experienced in both of the oil shocks, each of which lasted several years, we found that NATS would have been unable to reach its debt service obligations." It shows, does it not, that a down turn as bad as either of the oil shocks would have left NATS unable to meet its debt service commitment? It does show that, does it not? Paragraph 3.27 says that.

(*Ms Lomax*) We have not seen that.

223. It does say that. Did your Department realise this and decide to ignore it or did your Department fail to realise that NATS' finances would not be

[16] Ev 31.

[17] Ev 31.

[18] Ev 31, 35.

[19] Ev 31.

[**Chairman** *Cont*]

robust? Which of those two did you do? Did you ignore the information that was given to you or did you realise NATS' finances would not be robust? Did your Department realise this?

(*Ms Lomax*) Can I approach the question from a different end and explain why I succeeded in confusing everybody, because I did not mean to quarrel with the NAO Report and I got led into it by simply assuming that the figures in Table 21 were the same as the figures in Table 23, or whatever it was, which was flights. The confusion arises because it is a fact that chargeable service units are not available on a consistent basis before 1983. I want to get into why I confused you, I will come to it in the end. The material that you have got in Table 21, chargeable service units—

224. Do not go too quickly.

(*Ms Lomax*)—where we got into confusion is the table which shows different scenarios. What the NAO says is, look at these scenarios, they did not test them and when we tested them they showed that the bid was financially flawed. When I said that while we might not have tested exactly these, enormously extensive stress testing was done which showed that the bid was robust, we got into great confusion and you said, did you or did you not do these and I said these are on a different basis. Let me go back. Table 21 I had assumed, was flights because everything else is in terms of flights. The reason I assumed that it was flights is because I know that before 1983 chargeable service units are not available on the same basis as post 1983. What has happened, I have now had advice from behind me, is that NAO extrapolated these figures from flight data and basically recreated a series for chargeable service units before 1983. This was a subject for some unhappiness while the Report was being prepared. But I should not have mentioned it because we basically decided not to push it.

225. Jeremy, will you help me on this, will you try and explain to the Committee what is going on?

(*Mr Colman*) I agree with every word Ms Lomax has just said. There was discussion, the scenarios in grey in Figure 21 are scenarios that we constructed extrapolating from data regarding flights. Our point is that these were scenarios that were markedly worse than those that are in blue, however they are measured. We asked the Department whether they had tested the robustness of the model against those scenarios. We did our own modelling, which is what 3.27 is about, which suggests that either of the oil shocks, were they to have been repeated with the NATS' financial structure in place, would have caused difficulties. 3.27 is reporting NAO's analysis.

(*Ms Lomax*) Not shared with the Department or CSFB. My answer is what you say is interesting and I fully accept that we did not challenge this, and I must say I walked into this debate by mistake. The point I was trying to make is, it is a highly technical business testing these bids, they were tested extensively against a wide range of scenarios, volumes and volumes of scenarios were tested.

Mr Davidson

226. Surely that is what your advisers got £40 million for?

(*Ms Lomax*) That is exactly what they were for and that is what they were doing to earn this huge amount of money. They did not specifically test a repeat of 1973 and 1979, but they did test—

Chairman

227. Why did they not do that, after all we had had 1973 and 1979?

(*Ms Lomax*) Why did they not? I have had two answers to this. They did test scenarios which they regarded as severe but more relevant, a sustained period of low growth for 10 years and a sudden shock to CSUs in the scale of the Gulf War. In both cases the Airline Group bid was robust, NATS did not run out of money. They also asked themselves a different question, which is not discussed here, how severe a shock would there have to be to cause this real trouble to this financial model? The answer they got was one which was regarded as so extreme as not to be worth pursuing. The real issues that I was trying to explain is the problem is that peoples' imagination of the situation in May did not embrace a situation as severe as actually happened. You can do an awful lot of arithmetic if you like but if you think the world is a safer place than it was—it is complicated, but very, very many scenarios were tested. The point that is being made, the general point that the NAO is making, which I am taking issue with, is that the Department did not do due diligence on these bids. I am challenging that. The Department took good advice and did extensive testing of all of the bids which people at the time thought was relevant. Did they do enough? In the light of what has happened they did not. Basically the world turned out to be altogether capable of more savage downturns than we had realised before.[20]

228. That is not the point. We are not on the point of more savage downturns. I must come back to the NAO here, what you are telling us, the NAO, is that if there had been a study done on what might happen on the same scale as the oil shocks this deal would not have been robust?

(*Mr Colman*) That is what our modelling suggested. Paragraph 3.28 shows the results of our discussion with the Department's advisers CSFB. Their view was that it would be inefficient to leave capital lying round in NATS, as it were, waiting for such a shock. It is clearly possible to have a debate about whether that is sound or not. The consequence is if you do not leave the capital in and shock occurs you have to do something about it.

[20] *Note by witness:* My answer appears to imply that a specific test was done to establish how severe a shock would have been required for the company to have been unable to meet its debt obligations. As I explain in my supplementary memorandum to the Committee, it is more accurate to say that, given the assumptions used for the testing, the set of events would have had to be so severe that it was not worth establishing the precise point at which failure would have occurred. *See* Ev 24.

[**Chairman** *Cont*]

(*Ms Lomax*) Can I suggest that is a different point, that it is not worth looking at these downside shocks, there are other mechanisms to cope with them and therefore we should not put in reserves or whatever you are suggesting in your recommendations. If you did the modelling we have not seen it.

Mr Williams

229. That makes it worse because they did not take into account the basic point which has been asked on several occasions, that anything that affected or created a down turn for NATS would create a down turn for the shareholders, for the seven air companies and therefore it was incompetent to give the advice they gave but it was better for the shareholders to respond to the company's needs as risk transpired because the sort of risk we are talking about would affect them all equally or approximately equally.

(*Ms Lomax*) That is another point and I would like to respond to it. We established a regulatory system which can respond to exceptional events. There is a clause in the NATS' licence which specifically permits an exceptional user contribution if something happens which impairs the ability of both the shareholders and NATS to respond in the way that you are worrying about. We did think about that particular scenario. That is why it has got that clause in the licence. Also at the moment the PPP is coping with such a situation without falling apart. The CAA is negotiating with NATS on a composite solution where the burden will be shared between users, shareholders, investors and the company.

(*Mr Everitt*) And the company.

(*Ms Lomax*) And the company. The company is having to make adjustments which if it had remained in the public sector it would not have had to make.

230. Surely that leaves all the risk with one shareholder, the Government?

(*Ms Lomax*) No, it does not.

231. Who else could carry the risk?

(*Ms Lomax*) The risk is being spread between users through higher user charges. In all other air traffic control bodies the risk has been passed straight on to users in the form of higher charges. Most of the other air traffic control bodies put up their charges by amounts ranging from 6%, 10% or even more. NAVCANADA put theirs up by 10%. It is in the annex to this Report. That is one way in which the risk can be carried. Banks are having to participate in a refinancing of the loan and we are finding another equity shareholder, and the Government as a responsible shareholder who has agreed to put in some money to match. It is not just simply coming back to the Government.

Chairman: Obviously, as my colleague says, we will want to be kept informed on how this develops.

Geraint Davies

232. Just one final clarification on these three grey columns. It seems to me that what these three grey columns show is that every 10 years there has been a scenario in which the NATS model does not stand up to this sort of shock. The next 10-year shock happened to be 11 September but history shows us that it was not just one event, it was three events in 30 years. It seems remarkable therefore that those three scenarios which occurred, as opposed to a hypothetical scenario we could never have managed, were not factored into what we were proposing and in fact they would not stand up to financial scrutiny.

(*Ms Lomax*) Can I make one observation which is that the four separate committees of the banks who were putting in a very large amount of money into this bid, and who want to be repaid, looked independently at downside scenarios and stress tested these bids. It is not just something that was down to our advisers in the Department.

233. So none of them asked the question what would happen if the 1979 or the1983 with the Gulf War oil shocks occurred—

(*Ms Lomax*) The conclusion that was drawn was that the bids were robust against foreseeable shocks at that stage. As I say, what was—

234. You do not agree that history is the foreseeable future?

(*Ms Lomax*) If you go back you could say, "Why do you not replay the Second World War?" What is relevant is what people think will happen in the world in which we live at the moment, and people's views on that change.

Mr Williams

235. This was foreseeing for 20 years ahead, not a year or two ahead, so how can you justify not taking into account the fact that we are in one of the most volatile areas in the world where the aircraft industry is very vulnerable, but we completely ignore the experience of the previous 20 years, because when you were doing this the 1979 shock was within the 20-year period.

(*Ms Lomax*) I do not want to argue that, in the world as it has now developed, enough downside testing was done. The thing that I am trying to throw doubt on is the idea that there was a perfectly obvious piece of downside scenario testing which should have been done which we utterly failed to do. I do not think that is a fair description of what went on. I think there was a very conscientious attempt to test these bids against the very wide range of scenarios, but they did not predict 11 September.

Geraint Davies

236. It is the case that OPEC still exists and Saddam Hussain still exists, so the causes of those three shocks are still there, are they not?

(*Mr Everitt*) Can I make a point here. There is a very important condition in our licence that if we experience exceptional circumstances as they are defined—and I think by any standards the oil shocks of the 1970s and 1980s (and I was certainly in the industry when that was experienced) would be exceptional—the regulator can step in. This is not an unusual provision. You will find something similar, I am sure, in other regulated environments. The difference compared with NAVCANADA is that NAVCANADA have control over what their price levels will be. You have heard they went up 6% last January and they are going up 3% this January. Here

[**Geraint Davies** *Cont*]

we have a regulator who arbitrates, in effect, between the company and the users, and I think the design of condition 25, the exceptional circumstances condition, was to try and make some provision for circumstances of the type that could not be envisaged that we might experience and that is, in effect, although we are going under a different provision in the Transport Act, precisely what we are doing now. We are working through with all parties to this composite solution to deal with the totally unexpected and I think unforeseeable event.

Mr Davidson

237. One question for the National Audit Office, if I could, just for clarification. One of the issues that perplexed a lot of us during these debates was the question of NAVCANADA and whether or not its structure would be classified as in the public sector and therefore count against the borrowing requirement. Can you clarify for us whether or not in your understanding the UK Government were using the same criteria to judge what was going to be in the public sector borrowing requirement as a) Canada and b) equivalent European countries? If that is too hard without notice, I wonder if it would be possible to have a note on that, Chairman, because that was one of the main issues at the time as to whether or not a not-for-profit solution was possible and the argument was that the British Government were using different rules. We have now heard it was all the fault of the Office of National Statistics which is akin somewhat to saying "a bad boy did it and ran away" from the Treasury. I am not sure I entirely accept that analysis.

(*Mr Colman*) I would take the opportunity of putting in a note on that, if I may.[21]

Mr Rendel

238. I want to go back, I am afraid, to this whole question of the scenarios. I wanted to get one thing straight before I start. Paragraph 3.23 makes it clear that there were nine mandatory scenarios which were tested at the request of the Department. Both Nimbus and the Airline Group had to test those nine mandatory scenarios and only one of those dealt with adverse variations in traffic. So for some reason the Department decided not to ask for the sort of variations in traffic that happened, for example, during the oil crises because the only variation in traffic that was required was that the baseline assumption of 6.7% annual growth be reduced to 3.5%. There was still going to be a big increase in traffic but not as big as happened before so the Department did not require any scenarios with, for example, zero increase in traffic over three or four years?

(*Ms Lomax*) No, it did not.

239. Secondly, the groups were asked in paragraph 3.24 to show any further scenarios which had been requested, presumably by themselves or by their lender banks, so when you mentioned the lender banks all the testing that was required by the lender banks is included in these blue columns under figure 21, so we can see there everything that the bank has asked for. In paragraph 3.24 the Department requested sight of any further sensitivity testing which had been run on the bidders financial models.

(*Ms Lomax*) Those were what the airlines asked for.

240. All the banks and the Airline Group.

(*Ms Lomax*) Those are the ones the banks and Airline Group asked for.

241. Are you saying you also ran certain scenarios, not the mandatory ones the airlines were asked to run nor the ones that they chose to run, but some other scenarios which were run by CSFB as well, quite separate from these?

(*Ms Lomax*) Yes, and I gather that every scenario done by the other bidders, Nimbus for example, was also run by the Airline Group, so there was very extensive stress testing using all the scenarios anyone could think of.

242. And neither those that were requested mandatorily nor the ones the airline groups admitted to having done nor presumably the ones Nimbus had done included a period of two or three or four years at the beginning of the period under consideration when there was no increase in traffic?

(*Ms Lomax*) Two traffic scenarios were undertaken, one was a sustained period of low growth round about 3.5% in CSUs, the other was a sudden shock to CSUs in the scale of the Gulf War.

243. Is that the one that is said to be lower traffic in Year Six?

(*Ms Lomax*) The reason why it is in Year Six is because Year Six is the most difficult year, the year where it is most likely to fail. That is the one I am talking about.

244. That is the Gulf War.

(*Ms Lomax*) It was chosen because it was the most difficult year.

245. You did not do anything like the two oil shocks and nobody did anything like the two oil shocks. Did CSFB do something about the two oil shocks?

(*Ms Lomax*) They did tests which they thought were comparable in severity.

246. To the two oil shocks.

(*Ms Lomax*) The scenarios were based on looking at experience since 1983. I do not think anybody did—

247. They did not.

(*Ms Lomax*) Nobody modelled the two oil shocks as such, the comparable data was not available.

Mr Rendel: Nobody but nobody in all of these people who are doing the testing, whether it is CSFB, the mandatory testing, the bank or whether it is the Airline Group, nobody but nobody modelled the oil shocks. Personally I find that quite extraordinary. You did go on to say that the advisers were then asked to see what scenario would make the finances non-viable. You went on to say that they found that the only scenario that would make finances not viable was so extreme that it was not to be credible. The oil shock scenario made the finances non-viable, we are told that, because it was modelled eventually

[21] Ev 36–37.

[**Mr Rendel** *Cont*]

by the NAO. We are told that in paragraph 3.27. Why did the advisers not discover that an oil shocks scenario—which could not be described as non-credible because it happened twice—would make the finances non-viable. The advisers seem to have let you down very badly.

Chairman

248. We have made our point. Do you want to have one last stab at it?

(*Ms Lomax*) What I can do is send you a detailed note on what the stress testing was and our comments on the points that have been made.[22] I think I am making the same points over and over again.

249. We are in danger of going round and round.

(*Ms Lomax*) You deserve to have the best written account we can on this important point. I will end by saying we have not seen the NAO's work, I am sure it is up to standard, but we have not seen it, and it would be good if we could see it now please.

Mr Jenkins

250. The pension fund, normally companies take holidays from making a contribution because the stock market is very high and they have figures that show they can meet their obligations. In a case where we take a pension holiday because of the financial position of a company, Ms Lomax, as a majority shareholder in this corporation would you realise how embarrassing it would be if the company would fail in its obligations or meet its obligations to the pension fund. Are you taking a very close role in monitoring to ensure that this will not happen?

(*Ms Lomax*) I personally am not but I am sure the partnership directors we have appointed to represent the interests of the government certainly are.

[22] Ev 26–28.

251. Can you guarantee you will not come back and say, we cannot meet our obligations in the pension fund?

(*Ms Lomax*) I cannot give you any guarantee of that sort, nobody ever can.

Mr Howarth

252. Can I make a brief point, it seems to me the reason we have probably spent the last half hour or more of this extended meeting of the Committee is that when the Department, presumably the Permanent Secretary, signed off the NAO's Report they were accepting the integrity of the comparison that the NAO were making. I think it would have been better if you had doubts about that to have taken that up at the time, it might have saved a lot of difficulty here today and us getting into a lot of territory that has become baffling to many of us.

(*Ms Lomax*) I fully accept that and I apologise to the Committee. I think I got dragged into it as a result of trying to justify the amount of stress testing that had been done. I think it is a highly complicated and technical area. If I have confused the Committee I will try and put it right when I send a further note.

Chairman: Thank you very much, Ms Lomax and Mr Everitt, for coming to see us. We will obviously return to this in our report. As you might imagine, we may have a lot to say about whether the way this PPP was handled put the company into financial distress. Before I end I am indebted to Mr Geraint Davies for a quote from Adam Smith who wrote this a long time ago: "The tolls for the maintenance of the high road cannot with any safety be made the property of private persons because they might neglect altogether the repair of the road and yet continue to levy very nearly the same tolls." Let's hope we can learn from the wisdom of the past. Thank you very much.

Letter from KLM Buzz and RyanAir to the Chairman of the Committee

NATIONAL AIR TRAFFIC SERVICES REVIEW

We are writing to you in your role as the Chairman of the Committee of Public Accounts. We listened with interest to the evidence session at the House of Commons on Monday 18 November and were interested to hear some of the points raised by the witnesses from the Department for Transport and NATS, as well as members of your Committee.

Neither RyanAir nor KLM Buzz are members of the Airline Group of NATS shareholders. As such, we were particularly interested to see if last Monday's Select Committee hearing would clarify the two key areas of the ongoing CAA consultation on NATS charges that are a particular concern; namely, the proposals for increased financial contributions from NATS users (with no accompanying service level improvements) and the increase in sharing of risk.

We hope you will not object if we take this opportunity to raise some further points with you and the whole Committee as we feel these issues might also prove useful in helping the Committee to write its final report.

1. *National Audit Office report on NATS*

We share the Committee's concern over the fact that the DfT had apparently signed off the National Audit Office's Report on NATS whilst, as the Committee highlighted, some points still needed to be clarified. We hope that the Committee will receive a satisfactory response from the DfT and that clarification will be made known to us in due course.

2. *Increased NATS charges*

As you are of course aware, the Airline Group paid £60 million in return for a 46% shareholding in NATS. Users of NATS (both the Airline Group and non-Airline Group members) are now being asked to make a "one-off" exceptional contribution of some £56 million up to 2005. This does not include any element of risk sharing. In addition, users could potentially be expected to make a further "one-off contribution" in 2006 amounting to some £53 million.

Whilst the Government and BAA are to contribute an additional £65 million each, this will not be cost free and returns will have to be paid to them, Other NATS users such as ourselves, however, will be "contributing" a significant sum of money and will receive nothing in return and as we say above, there are no promised improvements in existing service levels. Whilst it is true that the Airline Group will be contributing part of this additional £56 million, we feel that this is not unreasonable, given that they are shareholders of NATS and under normal commercial conditions would be expected to find the additional funding by themselves. It should also be noted that the Airline Group are shareholders and, as such, will get a return on their investment at some stage, as well as owning shares which can only increase in value.

The situation of users having to make a contribution in this way without being treated the same as other investors seems very inequitable. We would welcome your views on this.

3. *Stress testing*

We were particularly interested to hear the discussion on stress testing. It is interesting to note also that the CAA, in arriving at their recent proposals, do not appear to have run any testing on the impact that increased NATS pricing will have on various sectors of the industry. This is somewhat surprising given that charges will increase at a time when airlines will be least able to afford an increase due to a reduction in revenue streams.

4. *Safety*

NATS operates a safe system and will do so in the future. Safety is of paramount importance to us. A safe system could be achieved with increased system capacity if NATS was staffed to its full complement and ran at full efficiency. Given that this doesn't happen, a safe system is only achieved by reducing capacity. NATS Management and resourcing are key.

NATS has achieved a safe system by cutting back on the available capacity, which is causing delays for airlines. Air Traffic Control accounts for some 34% of our total delayed and cancelled flights. If the current proposed EC legislation on compensation for passengers in cases of delayed and cancelled flights were to go ahead, we would be faced with significant compensation payments as a result of NATS delays (related to NATS own logistical issues), but would be unable to counter claim on NATS as they are exempt from making payments of this sort. There is no incentive for this incredibly important function to put its house in order. in the meantime, airlines such as ourselves, struggling in a competitive market, will have to bear the consequences of EU legislative change on delays with no means of passing that on as appropriate to the body responsible for 34% of our delays.

Safety remains the most important thing to both our organisations. We do not feel it appropriate for it to be used as cover for NATS performance failures.

5. *Additional points of relevance to the Committee*

We would also like to bring to your attention the following points:

- NATS has increased the number of sectors to distribute the workload—but it is unable to staff the sectors sufficiently and, as a result, several of these can be short of adequate staffing at any one time.
- NATS is confident that, once the refinancing has been completed, demand will not exceed capacity—whilst this may be true in theory, it will depend on sufficient staffing being available at any one time.
- The Composite solution as proposed by the CAA in its current consultation does spread risk, but we would argue that it does not spread risk equally.
- The comment made by Ms Eagle, that Treasury rules should be looked at, is correct.[23] Had the Treasury been more flexible in the first place and more in line with other Member States, NATS could have been released from the PSBR and been free to borrow on the open market. This could have avoided the current NATS situation.
- We do not know what the user contribution will be in the future—in effect, we are being asked to sign a blank cheque.

[23] Qq 87–91.

— Amongst all EU Member States' air traffic control systems, we believe that NATS gives worst value for money.

— NATS mentioned that it hopes to diversify in the future. We are helping them to do so. It seems unfair that we are being forced to make a contribution now and that this will help NATS to become more financially stable so that they are able to diversify and increase the value to shareholders at a later stage.

Senior management from our organisations would be happy to meet with you in the near future to discuss some of the points raised in this letter. We employ many people in Britain and millions of UK citizens use our services every week. We are proud to operate successfully here and hope to grow in the future and thus contribute more to the UK economy. It is very important to us that members of the Committee understand our concerns and we would have communicated earlier had we known of the Committee's vital work.

Jan Skeels	*Jim Callaghan*
KLM Buzz	RyanAir

25 November 2002

Supplementary memorandum from the Permanent Secretary, Department for Transport

When I appeared before the Committee on 18 November 2002, Mr David Rendel MP questioned me about the extent to which the robustness of the financial structure of National Air Traffic Services (NATS) had been tested for possible reductions in air traffic. I promised a note of explanation. This memorandum also covers the supplementary questions sent to me by the Committee. It has been discussed with the National Audit Office.

In the course of responding to Mr Rendel, I questioned figure 21 in the Comptroller and Auditor General's (C&AG's) Report. That led to some confusion, which I hope I can now clear up. The figure shows the impact of a number of tests to which the Airline Group bid was subjected and three further tests run by the National Audit Office (NAO) in the course of their examination of the public private partnership (PPP). The NAO tests were based on the oil crises of 1973 and 1979 and the Gulf War of 1990. The figure is calibrated in chargeable service units (CSUs). I pointed out that CSU data were not available in respect of the period of the two oil crises. I was not aware that in running their three tests the NAO had estimated the number of CSUs for the critical years from the available data for the total number of flights in UK airspace. The NAO point out that they had discussed their approach with the relevant experts at NATS, and officials in the Department did not query it. As I said at the hearing, I accept that.

The C&AG's Report rightly says that the Airline Group bid was subjected to nineteen tests of its financial robustness. Nine mandatory tests were applied to all bids. The final Airline Group bid was subjected to a further 10 tests. Whereas the mandatory tests addressed the impact of various kinds of long-running under-achievement, the additional tests focused on more specific, sharper shocks. The latter are the tests illustrated and briefly described in the first part of Figure 21 in the C&AG's Report. All 19 tests are listed in the Annex to this memorandum.

The tests were designed to examine a range of realistic possibilities to see how robust the financing was against plausible forecasting errors. The Airline Group bid passed all the tests, and this contributed to the conclusion that it offered a sufficiently sound financial structure. The tests were not designed to identify a set of events which would have made the company unable to meet its debt obligations. Given the assumptions used for the testing, that set of events would have had to be so extreme that the issue was not worth pursuing. It is therefore not possible to say from the tests what would have been the least disastrous scenario which would have pushed NATS into default.

The point of figure 21 is to demonstrate that there were historic events—notably the oil crises of the 1970s—which were not replicated in the tests to which the PPP bids were subjected. From the modelling which underlies figure 21, the NAO concluded that "given a reduction in traffic on the scale experienced in both of the oil shocks NATS would have been unable to meet its debt service obligations" (C&AG's Report, paragraph 3.27). The Department did not challenge that statement when commenting on the draft Report. We did question whether events so long ago were a good guide to what might happen in the future, but the NAO were keen to keep the comparison in the report and we did not press the point. At that time we did not ask for, and so were not offered, access to the NAO's modelling work. The C&AG's Report, which we agreed to in the normal way, presented the conclusions arising from this analysis.

We have now seen the NAO's modelling work. In the light of what we have seen, it is clear that in their three supplementary tests the NAO used the same model as was used in testing the Airline Group bid, but applied it differently. There were some differences in the way in which the year-on-year traffic comparisons were calculated. But the key difference is that the original range of scenarios assumed that the economic regulator would allow NATS' prices to increase if there were to be a major and sustained downturn in traffic, whereas the NAO tests did not.

The NAO comment that they consider it inappropriate to include assumptions about possible amelioration in stress tests, which they believe should be performed with all other things remaining equal. In this particular case, the NAO did not make an assumption that the regulator would make adjustments, and regard such an approach as questionable. In the original tests, on the other hand, the assumption was made (by the Department and its advisers, and by the bidders) that in each quinquennial review of NATS' charges the regulator would take all factors into account, including any material adverse events which had occurred during the preceding period. The financial regime was therefore regarded as sufficiently robust if it could withstand foreseeable shocks for the remainder of the control period in which the shocks occurred. Which methodology is correct is a matter of judgement.

One of the tests applied to the Airline Group bid was a reduction in traffic in Year Six of the PPP, that is, the first year of the second control period. This test was chosen because Year Six was the most difficult year for NATS' cash flow. The ability to withstand a shock in that year and to continue to service debt throughout the remainder of the second control period was therefore seen as the key test of the robustness of the bid.

The NAO say that they recognised that Year Six would be a difficult one, but noted that—given their assumption of no intervention by the regulator—the effects in this test would be mitigated by the previous five years of compound growth and by the accumulation of cash reserves. They say that this was a factor in leading them to look at other scenarios.

The C&AG's Report correctly states that the Airline Group bid was not explicitly tested against the possibility of traffic reductions as severe as those which occurred in the oil crises. However, if the methodology used for the original testing is now applied to an oil crisis scenario, the Airline Group bid would withstand such a test. That is to say, the test would have shown that NATS could continue to service debt throughout the first control period, after which the regulator could intervene to compensate NATS' for the loss of traffic in subsequent periods. The NAO methodology, on which the bid failed the test, was more pessimistic: it did not assume any adjustment by the regulator at the end of the first control period, and as a result it showed a default in later control periods.

There is a duty on the regulator under the Transport Act 2000 (among other duties) to ensure that NATS does not find it unduly difficult to finance its activities, and there is also a provision in NATS' operating licence allowing the price cap to be re-opened in exceptional circumstances. Given these facts, the Department considers that it was reasonable to assume that the regulator would adjust at the end of each control period for unusual events—adverse or favourable—in the preceding period. On that basis, the NAO methodology might be considered unnecessarily cautious. But we accept that the regulator had not at the time issued a statement of the regulatory policy it intended to adopt. In the absence at the time of such a statement, the extent to which one could assume intervention by the regulator was a matter of judgement.

The C&AG's Report comments on the fact that this regulatory uncertainty obtained during the bidding process. The report says that it was difficult for bidders to proceed without sure knowledge of the level of prices which NATS would be permitted to charge. I accept and support that comment. Among other things, it would have been helpful to have had a clear statement at an early stage of the regulator's intended approach for the second and subsequent control periods. This would have enabled the testing of the financial structure to have been conducted with greater confidence. Whilst the regulator had its reasons for delaying its regulatory statement in the present case, there is a lesson here for regulated businesses in the future.

December 2002

Annex

The Tests Applied to the PPP Bids

THE NINE MANDATORY TESTS

A. Capital expenditure by the licensed company 5% higher than base case in the first 10 years

B. Capital expenditure by the licensed company 10% higher than base case in the first 10 years

C. Wage inflation at 6.5% per annum for the first 10 years, compared with 5% in the base case

D. Tests A and C combined

E. Only 80% of planned redundancies achieved in the first charge control period

F. Low traffic growth—chargeable service units grow at 3.5% per annum for the first 10 years, compared with just over 4.5% in the base case

G. Only 50% of planned efficiency gains in non-staff operating costs achieved in the first charge control period

H. New Scottish Centre 30% over budget and two years late

I. Other factors leading to poorer results than envisaged in the base case (three variants)

The Ten Additional Tests of the Airline Group Bid

J. One year delay to both New Scottish Centre and the second stage of the New En Route centre

K. Higher penalty payments for delays than assumed in the base case

L. Contingency provision in capital expenditure plan 100% spent

M. Gulf War scenario: a significant shock in one year—a 2.5% year-on-year reduction in chargeable service units in Year Six (the equivalent reduction in the 12 months after the Gulf War was only 1%)

N. Certain categories of capital expenditure increased by 10% in the first and third charge control periods

O. Rate of return allowed by the regulator only 6.75%, compared with 7.75% in the base case

P. Corporation Tax incurred at 35% from day one

Q. London Inter-Bank Offer Rate increased to 8% from the start of the second charge control period

R. A combination of downside events, mainly occurring in the first charge control period

S. A combination of downside events, mainly occurring in the second charge control period

Supplementary memorandum submitted by National Air Traffic Services Ltd (NATS)

At the Committee hearing on 18 November, our Chief Executive, Richard Everitt, undertook to provide further information on a number of matters raised by Committee members. The information is set out below and follows the sequence of the transcript of evidence.

Q 99–101 (Geraint Davies): Price increases prior to the PPP transaction

The final revisions to NATS' charges prior to completion of the PPP transaction were introduced on 1 April 2001. With effect from that date NATS' UK en route and North Atlantic traffic charges became regulated under a new charge control formula. Income equalisation balances owed to customers under the previous charging regime were settled in the financial year. In addition, the responsibility for levying the charge and bearing the costs for meteorological services transferred to the Civil Aviation Authority. For en route services, the NATS' rate per chargeable service unit was reduced from £49.25 to £46.24 to reflect this transfer of costs and the new charge control formula.

The UK unit rate, which additionally includes the charges levied by the Civil Aviation Authority and the Department for Transport (which collects the UK's contribution to the costs of running the Eurocontrol organisation) decreased from £52.71 in January 2000 to £50.68 in January 2001. The rate increased to £52.59 in April 2001, reflecting the adjustments referred to above.

The North Atlantic traffic charge increased from £55 per flight to £55.55 per flight in April 2001.

Q 111–114 (Geraint Davies): Duration of training for air traffic controllers

As the NAO Report (paragraph 3.12) explains, NATS hopes to achieve significantly higher pass rates through more selective recruitment and more effective training, and by shortening the period of "on-the-job" training. It is, as Richard Everitt explained to the Committee, an aspirational goal towards which NATS is working.

On-the-job or validation training periods vary from operational unit to operational unit depending on the task and the training required for it. The Company has established study groups within our air traffic control centres looking at ways of making controller training more effective. The groups will be looking at a variety of issues including, for example, options for changes in procedures, greater use of simulators and so on. This work is being taken forward with the involvement of the trades unions and changes in training methods will be subject to scrutiny and approval by the CAA's Safety Regulation Group. Recommendations from the groups are expected in the first half of 2003.

Q 121 (Geraint Davies): Night Radar at Edinburgh

The background to this question is not entirely clear, since Edinburgh already has 24 hour radar coverage. In the past, NATS rostered two air traffic controllers at night to provide the ATC service at Edinburgh Airport. In order to allow the controllers to take their breaks a Notice to Airmen would be issued setting out the times when the radar service was not available. With increasing levels of traffic NATS decided that it wished to increase the number of controllers rostered to three to provide cover for breaks and hence provide a continuous radar service. Following discussions with the airport owners and the airline users of Edinburgh Airport this was agreed. NATS has provided a 24 hour radar service at Edinburgh for approximately the last two years.

Q 168–188 (Mr Davidson, Chairman, Mr Bacon): Pay and bonuses for directors and senior managers

Mr Bacon explained that he had difficulty in understanding the table in the NATS Annual Report and Accounts which sets out directors emoluments in the financial year 2001–02. The table is attached at Annex 1.

It would appear that Mr Bacon's reference to a 70% increase in what he termed the "cost of the upper range of management" is most probably a reference to the increase in payments made to directors between 2000–01 and 2001–02—ie the difference in the table at Annex 1 between £683.8k and £1,166.8k. The latter figure is a combination of £1,105.3k (the total for 2002 at the top of the page) and £61.5k (the total for 2002 at the bottom of the page).

As will be clear from the table, this 70.6% increase in Board costs is almost entirely accounted for by payments made in respect of compensation for loss of office (£311.3k), and the additional fees of the three Partnership directors appointed by the Government (£61.5k). The compensation payments were made to members of the NATS Board who were required to resign when the PPP transaction was completed, in particular to Sir Roy McNulty (who subsequently went on to become Chairman of the Civil Aviation Authority) and to Mr Bill Semple (who was subsequently appointed as a NATS Partnership Director). Both appointments were made through open competition.

At a recent annual conference of the air traffic controllers branch of the trade union, Prospect, a motion was passed criticising the "bonus payments" paid to Mr Semple and another senior manager, Mr Colin Chisholm. Prospect has since apologised to Mr Semple, because the union had advised Mr Semple (a union member) on the terms of his severance arrangements and had determined them to be fair. The union had also actively supported his candidature as a Partnership Director.

Prospect have also sought to distance themselves from misreporting in the media about bonus payments made to Mr Chisholm. The table at Annex 1 explains that Mr Chisholm received a bonus of £62.1k in 2001–02. £22.7k of this sum was for successfully achieving targets in relation to safety performance and delays. The operational performance of NATS in 2001 was exceptionally good, as was made clear in the foreward to the UK Airprox Board's Report for 2001. The Chairman of the Board, which is independent of NATS, wrote: "These latest [airprox] statistics show that trends on total airprox numbers in UK airspace continue to decline by small but important margins. During 2001 a total of 195 Airprox were filed for assessment. This figure is the lowest annual total since combined pilot/controller records began in 1990. Incidents involving Commercial Air Transport aircraft fell sharply to 82. Moreover there were no Risk A cases at all. Sixty-four were risk C—no risk of collision". We believe it is reasonable to provide a modest incentive to the head of the UK's air traffic control operation to maintain and improve flight safety.

We reported in our earlier memorandum to the Committee that there had been six NATS attributable risk bearing Airprox incidents in 2002, compared to nine in 2001. However, following recent assessments made by the UK Airprox Board of incidents earlier in the year, the total to the end of November has now been revised down to five. None of these were Risk A incidents.

Mr Chisholm also received a special bonus (£39.4k) for bringing the Swanwick Centre into operation in January this year. The development of Swanwick was the most complex project ever undertaken by NATS and, following serious technical problems in the mid 1990s, a number of steps were taken to get the project back on track. The turning point came in 1998 when Mr Chisholm was given the accountability for re-planning the project and managing the programme through to its completion. The plan presented by Mr Chisholm to the NATS Board in February 1999 achieved all of its major milestones in respect of software development, the programme of controller conversion training, and the schedule for project completion. Since completion, the system has continued to be robust in operation—the system having failed once in May, which is a far better track record than almost any other new computer system of equivalent complexity. Mr Chisholm received the bonus for successfully delivering into operational service a project costing £623 million, against the schedule agreed in February 1999. There have been problems with staffing at Swanwick this year, but our view is that a bonus payment for completing a project of this complexity and importance to the UK economy is appropriate.

The other director to receive a bonus in 2001–02 was Mr Nigel Fotherby. His main task in 2001 was to ensure that the company's role in the financial and project management aspects of the PPP transaction was conducted diligently and effectively. This involved an exceptional amount of work and the outcome, which resulted in proceeds to the taxpayer of getting on for £800 million, was reflected in a bonus to Mr Fotherby of £24.1k. There is no criticism in the National Audit Office Report of the role played by the NATS' finance team in determining the financial structure of the company.

It should be noted that the Annual Report and Accounts in question covers the financial year 2001–02. The general arrangements for the bonus scheme were thus set while NATS was still in the public sector, before the PPP transaction was completed. The scheme was contractual in nature and lacked any "ability to pay" clause, however the Report explains that, in practice, the 2001–02 bonus awards were scaled back reflecting the company's financial difficulties. The Report also makes clear that there was no general salary increase for managers in April 2002. This constraint applied to the individuals referred to above.

The inference in Mr Bacon's question is that NATS operates an unreasonably generous bonus scheme for executives and that this is a consequence of the PPP. This is clearly not so given the nature of the scheme and the sums involved. The current scheme is explained in more detail in paragraphs 4.15 and 4.16 of the NAO Report.

Q 188–192 (Mr Bacon): Shortage of controllers at Swanwick

At Swanwick, in the summer peak period in 2002, NATS was 34 air traffic controllers below the complement required for a 24/25 sector operational configuration. Staffing requirements are lower in the off-peak winter period.

Following the end of the summer peak period, a significant re-sectorisation of airspace over the Irish Sea has been introduced, re-arranging the boundaries between some internal London sectors and transferring some routes from Swanwick to the Scottish Area Control Centre at Prestwick. Before summer 2003 a major reorganisation of North Sea airspace (and the consequent transfer of Sector 33 to Prestwick) will reduce manpower requirements at Swanwick. Current forecasts show a potential shortfall of around 12 controllers next year and measures to manage this shortfall are in hand. A more detailed analysis of the statistics is at Annex 2.

As part of their recent pay settlement, controllers have been offered the opportunity to work Additional Voluntary Attendances (AVAs). Around 120 have already volunteered to attend, and the number continues to increase. Controllers' hours of attendance are regulated by the CAA's Safety Regulation Group, and these additional attendances will fall within the regulated hours. Other actions are in hand to increase the supply of controllers in the longer term including, as noted above, the steps being taken to shorten and improve controller training procedures.

Q 193–197 (Mr Bacon): Days of leave bought back and days owed to controllers

The background to this question is that the number of days of leave owed to operational staff rose significantly during 2001 as a result of the operational conversion training programme put in place to enable the London area control operation to transfer from West Drayton to Swanwick. With an intense training programme to be completed over a period of about a year, those most affected were the trainers themselves on the NERC Training Team (NTT), but all operational staff were affected to a greater or lesser extent. It has been calculated that operational staff at Swanwick are owed, on average, seven days "time off in lieu" (TOIL) of which about two thirds can be attributed directly to the training programme. In addition, staff at Swanwick are owed, on average, three and a half days of annual leave, giving a total of just over 10 days owed. There are considerable variations between individuals.

As part of the recent pay settlement, negotiations with the unions have been concluded for an agreement to "buy back" some or all of this outstanding leave entitlement on a voluntary basis. It is too soon to say what the full take up will be under the agreement, but priority will be given to those individuals with an above average number of days outstanding.

Q 197 (Mr Bacon): Increase in overload reports

The number of overloads reported so far in 2002 is 76 to the end of November, compared with 54 in 1999, 46 in 2000 and 37 in 2001. Of the 76, investigations have been completed on 56 and the majority (51) have been found to be associated with varying degrees of over delivery of traffic by the Central Flow Management Unit in Brussels against target sector flow rates. One has been found to be a safety significant event associated with the reporting of an Airprox incident. This latter incident is therefore the subject of an investigation by the UK Airprox Board.

The majority of these overload reports have been filed at Swanwick, indicating that there is a link between the opening of Swanwick and the increase in the number of overloads reported. Controllers are actively encouraged to file incident reports and some increase in reporting was expected while staff at Swanwick fully familiarised themselves with the new systems. The NATS Board is undertaking a review of the position on overload reports at Swanwick and the Board's Safety Review Committee will be visiting Swanwick for this purpose next month.

Q 198–200 (Mr Bacon): Changes to Form 1261

Mr Bacon's question appears to be based on a misunderstanding of incident reporting processes. Form 1261 is a Civil Aviation Authority form provided for the purpose of reporting incidents. NATS has no authority to change the form and alterations could only be initiated by the CAA. There have been no recent changes to the form. These forms are submitted to the CAA and are not signed by anyone other than the person who raised them. There is no section on the form for the watch manager or supervisor "to agree or not agree with the comment logged by the controller".

It seems likely that the question is directed at the Swanwick "ATC Safety Observation" process—a separate safety monitoring process whereby the watch manager or supervisor would in the past endorse a controller's view as to whether an Observation was safety related or not. At the suggestion of the local safety and quality management team at Swanwick, this system has recently been modified to give the endorsement role to the watch operational safety representatives. These watch safety representatives are responsible for promoting a strong safety culture at their units and supporting the safety observation process. They participated in updating the process.

Watch operational safety representatives are operational staff nominated by their colleagues on the watch, and are not in a line management role. The change has generally been very well received and the process is working effectively. If there are occasions when the watch safety representative is not available, the Observation form will be endorsed by the local supervisor or watch manager as before.

Q 201–215 (Mr Bacon): Article 88 Approvals

Mr Bacon posed two questions about NATS Article 88 approvals, based on a letter in his possession dated 22 January from Mr Dancer of the CAA to Mr Everitt. Specifically he asked whether the approval was temporary and, if so, what reason there was for the temporary nature of the approval. He suggested (Q207) that the reason was related to issues raised by the Health and Safety Executive.

The letter is not attached since it has presumably already been made available by Mr Bacon to other Committee members.[24] The letter begins as follows: "When I wrote to you on 24 October 2001 I advised that the Article 88 Air Navigation Order Approvals for NATS (En Route) Limited and NATS (Services) Ltd had again been time limited to enable anticipated changes to your structure and organisation to take place and be notified to the CAA. I understand that elements of the reorganisation have not yet taken place and on the assurance that the management structure of NATS remains as it was communicated to me on 20 December 2001 by Andrew Picton, your current Article 88 Approvals, which expire on 25 January 2002, are being replaced by further time limited approvals to enable completion of the reorganisation." Since the answers to both questions are contained in the letter, and are unrelated to the Health and Safety Executive, the purpose in asking them is unclear.

Q 215–217 (Mr Bacon): Increase in height capping since the opening of Swanwick

Mr Bacon asked how many journeys had been height capped at Swanwick and over the previous three years at West Drayton. For Committee members who may be less familiar with the terminology, "height capping" is simply a technique whereby an air traffic control provider is able to offer airlines a more prompt service at a lower flight level. It is generally more fuel efficient for aircraft to cruise at higher levels, but height capping is an alternative to delays when the requested flight level in the upper air routes is not available—eg because it is occupied by other traffic. It is true that in the summer season this year, there was a significant increase in the number of pilots accepting lower-level routeings, but this has now returned to more usual levels.

No statistics are kept on the numbers of flights that are height capped.

[24] Ev 41.

Q 218 (Chairman): Interest paid since the start of the PPP

The PPP was established on 26 July 2001 and interest charges on outstanding loans have since run at a monthly rate of around £4.3 million to £4.5 million.

Andrew Picton

13 December 2002

Annex 1

Emoluments (excluding pension arrangements) of the Chairman and directors were as follows:

		Salary and fees[11] **£000**	*Benefits* **£000**	*Performance related payments* **£000**	*Compensation for loss of office* **£000**	*Total 2002* **£000**	*Total 2001* £000
Chairman							
Sir Roy McNulty	1	**33.5**	**6.3**	—	**89.3**	**129.1**	165.3
Dr Chris Gibson-Smith	2	**72.9**	—	—	—	**72.9**	—
Deputy Chairman							
Bill Semple	3	**49.0**	**0.3**	—	**215.0**	**264.3**	180.1
Executive directors							
Richard Everitt	4	**194.6**	**36.0**	—	—	**230.6**	—
Colin Chisholm	10	**165.1**	**5.2**	**62.1**	—	**232.4**	161.0
Nigel Fotherby	5	**118.4**	**17.9**	**24.1**	—	**160.4**	137.8
Non-executive directors							
Rosemary Day	6	**4.3**	—	—	**3.5**	**7.8**	17.8
David Harvey	7	**4.3**	—	—	**3.5**	**7.8**	21.8
Silla Maizey	8	—	—	—	—	—	—
Nigel Turner	8	—	—	—	—	—	—
		642.1	**65.7**	**86.2**	**311.3**	**1,105.3**	683.8

Air Marshal Graham "Jock" Stirrup served as a director of the company until 25 July 2001 but received no remuneration from NATS.

1. Sir Roy McNulty resigned as a director of the company on 25 July 2001. He received compensation totalling £106,500 for loss of office including £9,000 in benefits in kind and £17,200 to augment his pension.

2. Dr Chris Gibson-Smith was appointed as Chairman with effect from 1 September 2001.

3. Bill Semple was an executive director until October 2000 when he became a non-executive director. He resigned as a director on 25 July 2001. He received compensation totalling £215,000 for loss of office including £500 in benefits in kind.

4. Richard Everitt was appointed director on 26 July 2001. The company paid contributions of £35,400 (2001—£nil) to a funded unapproved retirements benefits scheme to provide benefits in respect of earnings above the earnings cap. These benefits are excluded from the pension table below but are included in the directors' remuneration table.

5. The company paid contributions of £6,700 (2001—£2,300) to a funded unapproved retirements benefits scheme to provide benefits in respect of earnings above the earnings cap. These benefits are excluded from the pensions table below but are included in the directors' remuneration table.

6. Rosemary Day resigned as a director of the company on 25 July 2001. She received compensation totalling £3,500 for loss of office.

7. David Harvey resigned as a director of the company on 25 July 2001. He received compensation totalling £3,500 for loss of office.

8. These directors together with Danny Bernstein and Mike Lee who are directors of NATS Holdings Ltd are provided by the Airline Group who charge NATS Holdings £20,000 per quarter for the services of these four non-executive directors in accordance with the agreement signed on 26 July 2001. The total charge for the four directors for the period 26 July to 31 March was £53,300.

9. Richard Everitt informed the Board that he was foregoing any entitlement to a bonus for the year 2001–02.

10. Colin Chisholm's bonus is made up of an annual performance bonus of £22,700 and a special bonus for the opening of Swanwick of £39,400.

11. For year, or from date of appointment, or up to the date of resignation.

By agreement with the Board of the parent company, NATS Holdings Limited, the following information is provided in these accounts in respect of the additional members of the NATS Holdings Board.

Emoluments (excluding arrangements) of the other directors of NATS Holdings were as follows:

		Salary and fees[5] **£000**	*Benefits* **£000**	*Performance related payments* **£000**	*Total 2002* **£000**
Non-executive directors					
Bill Semple	1	**20.5**	—	—	**20.5**
Lord Brooke of Alverthorpe	2	**20.5**	—	—	**20.5**
Stephen Pettit	2	**20.5**	—	—	**20.5**
Danny Bernstein	3	—	—	—	—
Mike Lee	3	—	—	—	—
Pierre Jeaniot	4	—	—	—	—
		61.5	—	—	**61.5**

1. Following his resignation as a director of NATS on 25 July 2001, Bill Semple was re-appointed as a Partnership director of the company on 26 July 2001. The figure shown above represents the fees earned since that date.
2. Appointed director on 26 July 2001.
3. These directors together with Silla Maizey and Nigel Turner are provided by the Airline Group who charge NATS Holdings £20,000 per quarter for the services of these four non-executive directors in accordance with the agreement signed on 26 July 2001. The total charge for the four directors for the period 26 July 2001 to 31 March 2002 was £53,300.
4. Appointed director on 21 September 2001.
5. For year, or from date of appointment, or up to date of resignation.

Annex 2

SWANWICK ATCO NUMBERS

Requirement Summer 2002 (24/25 Sectors)		*Supply Summer 2002*		
Controllers	320	295		
Supervisors	50	50		
	370	345	Note 2	(340 FTE)
Watch Managers	5	5		
Training/Development	5	5		
	380	355		(350 FTE)
Traffic Managers	14	14		
	394	369		(364 FTE)
Allowance for Maternity				
Long Term Unfit	4 Note 1			
	398			Shortfall (34)

Notes

1. There was an assumption that long term medical unfits would not exceed those already known about (approx 5)

2. Some of these were part-time—the Full Time Equivalents (FTEs) number was 340.

Forecast Requirement for Summer 2003 (22 Sectors)		*Forecast Supply for Summer 2003*		
Controllers	290 FTE	287	FTE Note 1	
Supervisors	50	50		
	340 FTE	337	FTE	
Watch Managers	5	5		
Training/Development	10	10	Note 2	
	355	352		
Traffic Managers	14	14		
	369	366		
Allowance for Maternity	4		Note 3	
Long Term Unfit	5			
	378 FTE			Shortfall (12)

Notes
1. The forecast number of Tactical and Planner controllers is based upon the progress of existing trainees, actual retirements and an historical assumption of the losses. It also accounts for existing part-time workers and women due back from maternity leave who are expected to choose part time arrangements.
2. A higher allowance for training and development is required to meet the increased training demand and re-sectorisation plans to provide future capacity.
3. Maternity and Long Term Unfits already deducted from the controller supply number.

Further supplementary memorandum submitted by National Air Traffic Services Ltd (NATS)

Thank you for your e-mail of 17 February in which you seek answers to a number of additional questions regarding the Committee's inquiry into the NATS PPP. We spoke about this and I am sorry that Mr Bacon found the seven pages of detailed information provided in response to the last set of questions to be unclear and insubstantial given the considerable amount of work involved in their preparation.

My response to Mr Bacon's additional questions is as follows:

Days of Leave Bought Back and Days Owed to Controllers

What is the number of days off owed to controllers in total?

What is the number of days which have been bought back so far in total?

Since Mr Bacon's other questions are related to Swanwick, I presume this question is also intended to be related to Swanwick. However, if information is required about days off owed to staff at other en-route units, or at any of NATS' airport units, please let me know.

The position changes day by day but, at 28 February, 2,935 days were accrued for "time off in lieu". Days committed to be bought back were 1,337, leaving a balance of 1,598 days outstanding. It is estimated that a further 833 days will have been bought back by the end of April leaving a remainder of 765 owed from the period prior to 28 February (ie an average of around two days per controller).

Article 88 Approvals

How many Air Navigation Order (ANO) Article 88 Approvals have been received in total from the Civil Aviation Authority?

For each of the Article 88 Approvals, from what date did the Approvals (a) come into effect? and (b) expire?

There is no time limit given for this question, however it is presumably intended to relate to the period during which the PPP has been in existence. Prior to 26 July 2001 Article 88 Approvals were issued on a different basis to each operational air traffic service unit.

Since July 2001, the Civil Aviation Authority has issued Article 88 approvals to the two NATS operating subsidiaries—NATS (En Route) Ltd and NATS (Services) Ltd. These approvals are currently at version five, therefore 10 approvals have been issued. The dates are the same for both companies.

The dates when the approvals came into effect and expired are as follows. In all cases, as explained in my earlier letter, the approvals were temporary pending the completion of changes to the structure and organisation of NATS following the PPP. The current approvals are permanent unless revoked, varied or suspended.

Approval	*Date in effect*	*Date of Expiry*
001	26/7/01	31/10/01
002	1/11/01	25/1/02
003	26/1/02	26/7/02
004	27/7/02	31/1/03
005	1/2/03	Permanent

Height Capping

Since 22 January 2002, for how many days has height capping been in operation at Swanwick?

When height capping has been used at Swanwick, for how many hours has it been used on each occasion?

For how many days has height capping been in operation at West Drayton over the past three years?

When height capping has been used at West Drayton, for how many hours has it been used on each occasion?

I explained in my earlier letter that we do not collect statistics on the number of flights that are height capped. However I have re-checked the position and what I am able to provide is information which indicates the actual height levels of aircraft operating in the London Flight Information Region, disaggregated between aircraft operating above and below Flight Level 250. This is the dividing line for distinguishing between aircraft flying at low level and those operating in the upper airspace. This information is attached and covers the four years from 1999 to 2002.[25]

The data does not tell you whether these aircraft were flying at the flight level originally requested by the aircraft operator or at a height capped level. The data does however provide a general indication of whether there has been a material change between flight profiles for the three years from 1999 to 2001, before Swanwick opened, and for 2002, the first year after Swanwick entered operational service. As you will see from the tables, the introduction of Swanwick into operational service has made no discernible difference to the proportions of aircraft flying above and below Flight Level 250. If anything, there has been a slight decline in the number of low level flights. In 1999 (excluding flights outside controlled airspace) there were 1,209,464 air transport movements above Flight Level 250 and 481,385 below this flight level. In 2002, there were 1,285,208 flights above Flight Level 250 and 486,617 below this level. In other words, the ratio between high level and low level flights has hardly changed from 72% and 28% in 1999 to 73% and 27% in 2002.

It is not possible to provide the information requested in this latest set of questions about the hours and days when height capping has been in operation, because the information is neither collected nor retained, there being no operational or business reason for compiling such statistics.

Number of Validations

How many validations in total were held by air traffic controllers at Swanwick in each month since the start of operations in January 2002?

The method of calculating the total number of validations was changed in July 2002 and, in consequence, there is not a single data series going back to January of that year. The methodology was revised to provide greater accuracy in that it now excludes validated staff who are not available for rostering—for example because they are on maternity leave.

THE DATA SERIES IS AS FOLLOWS:

August	*September*	*October*	*November*	*December*	*January*	*February*
720	716	712	689	691	683	679

Where a controller has both a tactical and a planner validation on a single sector it is counted as a single validation

The number of validations is different from the number of staff in post because controllers may be valid on more than one sector. The reason for the decline in validations is that a number of controllers holding multiple validations have retired in this period and these staff have been replaced by new controllers holding single validations. For example, the percentage of controllers holding three skills has reduced over the period from 27.3% to 20.9%.

[25] Not printed.

As explained in my earlier letter, a major re-organisation of the airspace will be introduced shortly which, in addition to increasing the capacity of the system overall, will have the effect of reducing manpower requirements at Swanwick in the short term. As previously explained, there is anticipated to be a shortfall of 12 controllers on the requirement for the summer peak period.

Maintenance Budget

What is the annual maintenance budget for the Swanwick Air Traffic Control System?

Swanwick's maintenance budget for 2002–03 is £6.3 million.

Replacing the Swanwick Air Traffic Control System

What consideration has been given to replacing the Swanwick Air Traffic Control System and when is it expected that the Swanwick Air Traffic Control System will be replaced?

The NATS Business Plan for 2003–04 is currently being finalised. Subject to that caveat, the Plan envisages that the five main civil en route air traffic control centres in the UK (London Area Control Centre, London Terminal Control Centre, Manchester Area Control Centre, Scottish Area Control Centre and the Oceanic Area Control Centre) and collocated military units (London Mil and Scottish Mil), should be consolidated into two centres at Swanwick and Prestwick. The intention is that all of these operations, with the exception of the Oceanic Centre, will operate on a common system. A systems assessment process is underway and, subject to the approval of a detailed business case, it is envisaged that this new system will be introduced into operation at Prestwick in 2009 and at Swanwick in the early part of the next decade.

I hope this is helpful, though I have to say that the time and effort involved in preparing these responses seems disproportionate to the value of the exercise, given the fact that the matters raised are unrelated to the subject of the Committee's inquiry.

I am sending copies of this letter to the National Audit Office and to the Department for Transport.

Andrew Picton

10 March 2003

Supplementary memorandum submitted by the National Audit Office

In the Committee's hearing on 18 November 2002, the National Audit Office was asked by Mr Ian Davidson MP to clarify whether in considering the NavCanada not-for-profit model, the UK government were using the same criteria to judge what would be classified to the public sector in the UK national accounts as in, a) Canada and b) equivalent European countries.

The Office for National Statistics is the government agency responsible for compiling, analysing and disseminating many of the United Kingdom's statistics, including national accounts and the classification to the public sector. The Office for National Statistics produces the UK National Accounts in accordance with international standards defined in international statistical accounting manuals: the European System of Accounts 1995 (ESA95) and the System of National Accounts 1993 (SNA93). The former guidance is implemented in Europe and the latter standard, promulgated by the Organisation for Economic Co-operation and Development, and the United Nations, has also been implemented in Canada. So common rules therefore apply in the United Kingdom, Europe and Canada.

The classification rules state that an institution is classified according to who exercises control over ability to determine general corporate policy. In the case of NavCanada, this organisation is classified to Canada's private sector. As shown in Appendix 3 of the National Audit Office Report, the Canadian government directly nominates only three of the 15 directors on NavCanada's Board. It therefore appears that a structure on the NavCanada model could result in classification to the private sector in the UK national accounts, though this would be subject to detailed assessment of all corporate control mechanisms by the Office.

The Department did not obtain formal advice from the Office for National Statistics on the likely treatment of a possible option on the NavCanada model, which had not been worked up in such detail as the proposals for a PPP. However, discussions with the Treasury in 1997 had suggested that a not-for-profit model similar to NavCanada might be capable of being structured to achieve private sector classification in the UK national accounts. The Department did obtain formal advice, via the Treasury, from the Office for National Statistics, on the likely treatment of the NATS PPP in national accounts.

As shown in our Report, the Department chose the PPP model over the not-for-profit corporation because they considered it would provide better efficiency incentives, better access to private sector management and better incentives for NATS to do business overseas.

February 2003

Further supplementary memorandum submitted by the Department for Transport

During my appearance before your Committee on 18 November 2002, there was some discussion of the revised financial arrangements for NATS which were being negotiated at that time. The deal was completed [today], and I thought the Committee would wish to know the details.

When the Public Private Partnership (PPP) for NATS was created in July 2001, the Airline Group acquired a 46% stake in the company. The Government retained a 49% holding, and the employees received 5% in the form of a share trust.

BAA plc have now invested £65 million in NATS, and the Government has invested a matching amount on identical terms. Each investment of £65 million is comprised as follows:

(a) £5 million as ordinary share capital in NATS Holdings Ltd, the parent company in the NATS Group;

(b) £27.5 million of new loan notes in NATS Ltd, a subsidiary of NATS Holdings Ltd;

(c) £32.5 million of new loan notes in NATS (En Route) Ltd, a subsidiary of NATS Ltd that provides en route air traffic services in the UK under licence.

The investment by BAA will have an effect on shareholding levels. In round figures, BAA itself will have a 4% holding, while the Airline Group's interest will be reduced to 42%. The Government's share will remain at 49%, and that of the employees at 5%.

The Airline Group will continue to be the controlling shareholder. BAA will have the right to appoint two non-executive directors to the board of NATS Holdings Ltd. Its consent will be required for a limited number of NATS Holdings Ltd shareholder matters, and the approval of the BAA Directors will be required for a limited number of matters relating to the affairs of NATS Holdings Ltd or other members of the NATS Group.

The proceeds from the new investment will be used by NATS to effect a £130 million reduction in NATS' senior debt provided by its current lending banks. Thus the effect of the composite solution will be to reduce NATS' present and future senior debt exposure.

The new investment is only one element of the financial package for NATS. There are two other elements—changes to the company's existing debt facilities and changes to the regulatory environment in which it is operating.

The existing loan facilities had effectively been suspended pending the resolution of NATS' financial difficulties. These suspensions have now been lifted and NATS is free to continue its operations on a normal basis. Critically, this will allow it to continue with its capital expenditure programme to the ultimate benefit of users and the travelling public. The solution also envisages a refinancing through the issue of long-term debt in the capital markets. A significant step on the way to such a refinancing has been achieved with NATS receiving an investment grade rating from Standard and Poors.

The second additional element involves changes in NATS' regulatory regime. In December last year the CM announced that, following consultation with interested parties, it was prepared to approve conditional modifications to NATS' charges, subject to the CM being satisfied with the eventual financial restructuring package for NATS. The Authority therefore provisionally modified its price control so that the cap on price increases is now set at RPI—2% for the years 2003–05, compared to the previous limits of RPI—4% in 2003 and RPI—5% in 2004 and 2005. This will result in prices in 2005 being roughly 8% higher than they otherwise would have been. The CM also provisionally allowed NATS a dilution of volume risk over 2003–05, with the company bearing only 50% of volume risk, rather than 100%. The deal now reached has enabled the CM to formally approve these two conditional modifications.

The solution represents many months' hard work on the part of all interested parties—the shareholders, the bankers, the CM as regulator, and the company itself. Each party has made its own contribution, and borne its share of the risk. The Department believes that the deal is fair to both the taxpayer and all the other parties concerned.

I am writing in similar terms to Mrs Gwyneth Dunwoody MP as Chairman of the Transport Select Committee.

Rachel Lomax
Permanent Secretary

19 March 2003

Letter from the Committee to the Chief Executive of National Air Traffic Services Ltd (NATS)

Following your supplementary memorandum to the Committee, one of the Members of the Committee, Mr Richard Bacon MP, has requested some additional information relating to the hearing held on 18 November 2002.

The Committee would be grateful if you could provide a further note, addressing the following points:

— Since 22 January 2002, for how many days has height capping been used at Swanwick where height capping was imposed by air traffic control as a flow control initiative?

— When height capping has been used at Swanwick where height capping was imposed by air traffic control as a flow control initiative, between which hours was height capping used on each occasion?

— Over the past three years, for how many days has height capping been used at West Drayton where height capping was imposed by air traffic control as a flow control initiative?

— Over the past three years, when height capping has been used at West Drayton where height capping was imposed by air traffic control as a flow control initiative, between which hours was height capping used on each occasion?

3 April 2003

Reply from the Chief Executive of National Air Traffic Services Ltd (NATS) to the Committee

Thank you for your letter of 3 April seeking further information about height capping, on behalf of Mr Richard Bacon MP, following the Committee hearing on 18 November.

As you may be aware, there has been previous correspondence between your office and my Company Secretary, Andrew Picton, on this subject. I attach the relevant correspondence dated 13 December[26] and 10 March,[27] from which you will see that replies have already been provided to Mr Bacon's various questions and we have explained that we do not keep statistics on height capping. I therefore do not understand why Mr Bacon is now asking further questions on height capping which, to all intents and purposes, are identical to the questions posed in the Committee's e-mail to Mr Picton of 17 February and to which a detailed response has already been provided.

I can only re-iterate that we do not keep the statistics requested by Mr Bacon.

I am copying this letter to the National Audit Office and to the Department of Transport for information.

Richard Everitt

10 April 2003

Letter from the Committee to the Head of Flow Management Division, Eurocontrol

I am writing to you as part of the Public Accounts Committee's inquiry into the work of National Air Traffic Services Ltd and air traffic control in the United Kingdom.

The Committee is interested in flow control initiatives, particularly the procedure known as height capping or level capping. NATS have informed us that they do not keep statistics on the numbers of flights that are height capped and I am hoping that you may be able to assist the Committee.

The Committee would like to obtain an accurate and detailed picture of height capping activity in the United Kingdom in the three years prior to the opening of the Swanwick facility on 22 January 2002 and in the period since then up to the present date. By "height capping activity" I am not referring to those instances initiated by airlines, but rather those instances where height capping is imposed by air traffic control as an air traffic flow management measure.

The Committee very much hopes you will be able to provide detailed information in this area as follows:

1. For how many days has height capping been used at West Drayton where height capping was imposed by air traffic control as a flow control initiative:

(a) in the three years prior to 22 January 2002?; and

(b) in the period since 22 January 2002 to the present date?

2. When height capping has been used at West Drayton where height capping was imposed by air traffic control as a flow control initiative, between which hours was height capping used on each occasion:

(a) in the three years prior to 22 January 2002?; and

(b) in the period since 22 January 2002 to the present date?

[26] Ev 28–31.

[27] Ev 34–36.

3. Since 22 January 2002, for how many days has height capping been used at Swanwick where height capping was imposed by air traffic control as a flow control initiative?

4. When height capping has been used at Swanwick where height capping was imposed by air traffic control as a flow control initiative, between which hours was height capping used on each occasion?

5. In each of questions 1 – 4 above, how many aircraft movements were affected?

I do hope that you are able to assist the Committee in its work and I look forward to hearing from you.

8 July 2003

Reply from Mr Byrom, Head of Flow Management Division, Eurocontrol to the Committee

Thank you for your letter of 8 July about flight capping in UK airspace. I regret that statistics are not collected in the form requested in your letter. However, I hope it may assist the Committee in its deliberations if I explain how and why flight level capping is operated in European airspace and the statistics that are available from the Central Flow Management Unit (CFMU).

Flight level capping is the name given to the Air Traffic Flow Management (ATFM) procedure whereby a flight has a limit applied to the altitude/flight level at which it will be allowed to operate. This is usually applied to restrict the amount of air traffic entering a particular vertical sector of airspace in order to balance demand and capacity.

The introduction of reduced vertical separation minima (RVSM) created more useable flight levels above FL290. In order to optimise the use of these levels many Air Navigation Service Providers (ANSPs) redesigned the vertical sectorisation of their airspace. This created more capacity but this could only be realised if the demand could be shared between the different vertical sectors. Flight level capping is the method most employed to achieve this.

It is true that there is a cost to Aircraft Operators (AOs) in pursuing such a strategy since flights may be prevented from operating at their optimum flight level. Conversely there is an advantage in that such procedures usually reduce overall delay within the ATFM system.

Of course the imposition of a flight level capping procedure does not always result in aircraft not achieving their optimum flight level. At the moment there is no procedure in place to ensure that air traffic controllers do not change the flight level of level capped flights. Therefore the mere fact that a flight is captured in a flight level capping regulation does not mean that the regulation will be fully observed by all players. The result is that some traffic may still operate at their planned flight levels not their capped levels.

The data that we have in the CFMU pertaining to level capping is attached but I should perhaps give some introductory clarification. This data is based on the codes used to identify ATFM measures and it is true to say that until quite recently this coding has not been structured in such a way as to identify readily the causes for the application of a measure.

RVSM was introduced in the UK in April 2001, a year ahead of Europe as a whole in order to de-conflict such a major change from the opening of Swanwick in 2002.

Prior to RVSM there was very little level capping within the UK which is not surprising since the airspace structure was such that there would have been little capacity increase in so doing.

I would like to now address some of your specific points.

— For the above reasons it is extremely difficult, if not impossible, to give an accurate and detailed picture of height capping activity in the UK in the three years prior to the opening of Swanwick. Similar difficulties would also occur in quantifying the height capping activity in the rest of Europe. The reliable data for the UK covers the period from June 2002 and this will give you some indication of how the situation has developed in the UK post the Swanwick introduction. I believe it is safe to say that prior to this flight level capping was only used exceptionally if at all.
— In the attached data table it is necessary to explain the data in each column.
— The first column is the week in which the flight level capping (known as a scenario) was applied.
— The second column shows the number of flights that could have been affected based on the AO's flight planned intentions.
— The third column shows the duration of such scenarios in minutes.

When a scenario is applied it can be one of three types

— Institutionalised flight level capping between city pairs or between geographical areas. These are permanently applied and an example in the UK is between Manchester/Liverpool and the London Terminal Area where traffic is restricted to "not above FL190". Such restrictions are much more prevalent in Europe. In the UK there are only three such restrictions.

— A blanket restriction, known as a "zero rate" that is applied to a particular route on a tactical basis. For example in Swanwick's airspace the most common restriction would be to flight level cap aircraft flying between the South East of England and Scotland. Such a restriction would "free" extra capacity at higher levels for the traffic transiting the UK for entry onto the North Atlantic whilst possibly forcing the UK traffic to fly at less than optimum flight levels. This is a mandatory restriction and AO's are expected to adhere to it.

— Another form of scenario is the advisory one. Here AO's are advised to re-file at a different flight level in order to avoid delay caused by over demand. The AO is given the choice between delay or a less than optimum flight level. A criticism of this scenario is that AO's may not re-file and therefore the capacity available is not optimised and the delay attribution is increased.

Flight level capping is a common procedure within European airspace to optimise the use of available capacity in order to minimise attributed delay. Of course there is a cost to operators and the question is whether such costs are off set by delay reduction.

It is true to say that in the UK there had been a marked increase in flight level capping restrictions since July 2002 and that this has shown a marked reduction since the end of April 2003. At its peak there was in excess of 13,000 minutes of such restrictions per week, that is an average in excess of 30 hours of restriction per day. These restrictions impacted on average some 350 to 430 aircraft per day. Not all of these aircraft would have been subjected to flight level capping; some would have benefited from the optimisation of available capacity.

The above is my initial response to your letter and should you require a more detailed analysis please contact me. I hope I have given you some understanding of this complex area and that it will be beneficial to your Committee.

John Byrom
Head of Flow Management Division
Eurocontrol

29 July 2003

FLIGHT LEVEL CAP SCENARIOS FOR LONDON

Week	*Flights Entering Scenario TVS*	*Duration of Zero Rate FL CAP Regulations*
2002–24	1,703	7,020
2002–25	1,738	2,909
2002–26	1,759	540
2002–27	1,880	480
2002–28	1,655	5,270
2002–29	1,831	11,880
2002–30	1,747	16,200
2002–31	2,068	13,530
2002–32	2,138	12,720
2002–33	2,703	12,120
2002–34	2,807	16,240
2002–35	2,784	20,700
2002–36	2,900	14,180
2002–37	2,912	13,320
2002–38	2,984	7,920
2002–39	2,946	15,240
2002–40	3,066	13,860
2002–41	2,973	15,020
2002–42	2,893	13,860
2002–43	2,967	14,045
2002–44	3,105	12,870
2002–45	2,923	14,920
2002–46	3,043	13,860
2002–47	2,908	15,421
2002–48	2,934	13,860
2002–49	2,903	13,860
2002–50	3,001	13,860
2002–51	3,030	13,860
2002–52	2,432	3,960

Week	*Flights Entering Scenario TVS*	*Duration of Zero Rate FL CAP Regulations*
2003–01	2,952	4,740
2003–02	3,049	13,860
2003–03	2,980	13,860
2003–04	3,049	13,860
2003–05	3,053	13,860
2003–06	2,999	13,860
2003–07	3,016	13,860
2003–08	2,974	13,860
2003–09	3,063	13,860
2003–10	3,061	13,860
2003–11	2,984	14,400
2003–12	3,020	13,620
2003–13	3,063	13,500
2003–14	2,824	13,440
2003–15	2,848	13,440
2003–16	2,818	10,560
2003–17	2,794	13,920
2003–18	2,877	3,840
2003–19	2,865	260
2003–20	2,823	1,260
2003–21	2,922	0
2003–22	2,790	720
2003–23	2,860	600
2003–24	2,873	0
2003–25	2,848	0
2003–26	2,869	0
2003–27	2,826	340
2003–28	2,729	1,340
2003–29	2,834	1,320

Letter from the Civil Aviation Authority to Mr Richard Everitt, Chief Executive of NATS Holdings Limited

NATS ATS APPROVALS

When I wrote to you on 24 October 2001, I advised that the Article 88 Air Navigation Order Approvals for NATS (En Route) Limited and NATS (Services) Limited had again been time limited to enable anticipated changes to your structure and organisation to take place and be notified to the CAA. I understand that elements of the reorganisation have not yet taken place and on the assurance that the management structure of NATS remains as it was communicated to me on 20 December 2001 by Andrew Picton, your current Article 88 Approvals, which expire on 26 January 2002, are being replaced by further time limited approvals to enable completion of the reorganisation. The new Article 88 ATS Approvals, which run until 26 July 2002, have been issued to NATS Holdings Limited and sent under separate cover to the Company Secretary.

The new Article 88 Approval for NATS (En Route) Limited incorporates within its schedule the unit specific conditions for the two London Area Control Centres (LACCs) at Swanwick and West Drayton. This duplication is to enable a reversion following the commencement of Swanwick Operations on 27 January 2002 and will exist up to the time when this contingency arrangement is notified to the CAA, as being no longer required. At this point the NATS (En Route) Limited Article 88 Approval will be revoked and replaced with another without the LACC—West Drayton unit specific conditions. Additionally Article 104 and Article 105 approvals have been issued for the LACC—Swanwick and are held by the General Manager Gorden Doggett.

JC Dancer
Head of ATS Standards Department

22 January 2002

Civil Aviation Authority's Certificate of Approval for the Provision of Air Traffic Services issued to NATS on 22 January 2002 under Article 88

AIR NAVIGATION ORDER 2000, ARTICLE 88

APPROVAL FOR THE PROVISION OF AIR TRAFFIC SERVICES

The CAA, in exercise of its powers under Article 88 of the Air Navigation Order 2000 hereby approves:

NATS HOLDINGS LIMITED
acting by and through
NATS (EN-ROUTE) LTD (NERL)
to provide

Air Traffic Control Services

at

THE AIR TRAFFIC CONTROL UNITS SPECIFIED IN THE SCHEDULE

This approval is subject to the conditions stated in the schedule to this approval.

This approval is effective from the 26th January 2002 until the 26th July 2002 unless revoked, varied or suspended.

22nd January 2002

Signed and sealed by John Dancer

Approval No. NERL 003

Letter from the Civil Aviation Authority to the Chairman of the Committee

We have been requested, by the National Audit Office, to provide a formal response to the following question that arose from the Committee of Public Accounts report on the NATS Public/Private partnership:

WHY WERE NATS' ARTICLE 88 APPROVALS-TO-OPERATE TIME-LIMITED UNTIL 1/2/2003? WAS SWANWICK A FACTOR AND/OR WAS THE PPP?

NATS' Article 88 approvals-to-operate were time-limited until 1 February 2003 because it was anticipated that the new owners were likely to make changes to the NATS' corporate management structure and its interrelationships with its operational services post PPP. These factors are critical to NATS' Safety Management System, which is the basis on which NATS' approval is given, and the period between the PPP date and 1 February 2003 would have allowed the effects of any changes to be identified and to stabilise fully. Following a satisfactory audit by the CAA Safety Regulation Group's Air Traffic Services Standards Department, a continuous Article 88 Approval was given.

Thus the limitations were entirely PPP related and were not associated with Swanwick or the general provision of a safe operational air traffic service.

Richard Profit
Group Director Safety Regulation
Safety Regulation Group

7 October 2003

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