13 December 2022

Mr Rod Gander
Senior Policy Advisor – Consumers & Markets
Civil Aviation Authority
Aviation House
Gatwick Airport South
West Sussex RH6 0YR

By e-mail to economicregulation@caa.co.uk

Dear Mr Gander,

Loganair's response to CAP2934 – NATS En Route PLC price controls

Further to the CAA's publication in October 2022, I am writing to register Loganair's response to the CAA and NATS En-Route PLC ("NERL") charging proposals.

The short version of our response is that:

- the proposed 27% increase is completely untenable. It is broadly two and a half times the prevailing rate of UK inflation (which itself is at a 40-year high) and this leads us to question both NERL's ability to manage its cost-base and pension costs in particular, together with the CAA's ability to act as an effective regulator by allowing this to be tabled in the first place;

- Our view is that the maximum increase which could be contemplated is that of the current published CPI index. Failure to hold NERL to account against a reasonable yardstick would represent a failure of the regulatory regime under which it is managed;

- Any increase above CPI could only be countenanced if NERL actually delivers (as opposed to promising) a substantive programme of UK airspace change during the charging period – which unlocks value for air carriers that we can use to fund any further increase;

- Consistent with wider UK policy from the Union Connectivity Review and the reform of domestic Air Passenger Duty, future NERL charges must contain protections for UK domestic air services which recognise the essential role that domestic flights play in the wider UK economy. Other organisations such as Heathrow Airport have recognised this in their fees and charges, and NERL must be similarly compelled to do so.

NERL losses during the Covid-19 pandemic

The notion that NERL's charges should reflect recovery of losses during the pandemic is unacceptable to us.

In common with many businesses throughout the UK, NERL had full access to the CJRS "furlough" scheme and in the two financial years to 31 March 2022, claimed a total of £35.7 million in furlough income. There is no suggestion that this was anything other than a legitimate claim under the Scheme, yet at the same time, it's entirely unreasonable for NERL to hike charges to compensate for losses when it has already effectively had those losses covered by the UK Government via the CJRS.

According to its latest filed accounts (to 31 March 2022), staffing costs account for 60% of NERL's total operating costs. Having had full recourse to the CJRS scheme – which is the only support that most of NERL's airline customers had! – it reinforces the iniquitous nature of the charging increases to recover NERL's losses.

The fact that NERL has chosen to employ an accounting practice of recognising a large element of revenue that it thinks it should have had – a total of £619 million over two years – does not and should not condone this extraordinary accounting treatment of this "toxic debt", nor provide grounds for the CAA to allow this to be recovered via future charges.

Airlines such as Loganair fulfil a role which is akin, in a great many respects, to that of a public utility, maintaining essential air connectivity through the UK, just as NERL maintains essential air traffic control services as a utility company. However, we have no recourse or right to recognise revenue to which we believe we should have had some entitlement. The Covid-19 pandemic has been uniquely challenging for the entire industry, yet we have no ability to turn our problem into our customers' problem by ramping up charges to recover debts, as NERL is now proposing to do – and the CAA is proposing to sanction.

The price controls for the next regulatory period must thus be effectively set from zero, and any past liabilities from the Covid-19 pandemic should be discounted from the calculations even if NERL happens to have recognised these as some form of deferred income in its accounts. We see no basis to allow them, given the CJRS support and the hardship endured by the rest of the industry, its employees and its shareholders. Put another way, it is extraordinary that the CAA appears willing to sanction an accounting treatment in NERL's revenue recognition which no airline under the CAA's jurisdiction would ever be allowed to contemplate.

NATS cost controls

The proposals, and NERL's filed annual accounts, lay open a number of challenges around the operating efficiency of NERL and its management's control of costs. Uppermost amongst these is the question of management of NERL's pension liabilities; its pension costs in FY22 represented £81.6 million, which equates to 22.5% of its overall payroll costs.

By any measure, this is a material element of NERL's costs and highlights a historic and unfortunate approach to managing pension liabilities. Again, it is indicative of a business which is content to let its problem become its customers' problem and has not taken the same, prudent action that any private sector employer would be obligated to do. The introduction of a Defined Contribution scheme has to be welcomed, yet it appears evident to be a step taken several years too late. NERL's customers should not be held liable for this issue.

Airspace Modernisation

By far the greatest bone of contention for Loganair within the NERL charging proposals is the abject lack of progress by NERL to implement – as opposed to talking about – meaningful steps to modernise UK airspace.

Why does it take 22 minutes longer, on average, to fly from Dundee to London City than it does to fly from London City to Dundee? Why, up to 11 times a day, are our aeroplanes flying a 360-degree orbit over the village of New Alresford and affording our customers an aerial sightseeing tour of Winchester on many of our flights landing at Southampton? It is a standing joke of such magnitude that our pilots nickname it the "Winchester Wheel".

Outdated and inefficient design and usage of airspace is the answer on both counts.

Were tangible progress being achieved, we would – quite frankly – be open to consider the 27% proposed increase in NERL charges, for the cost savings and carbon reductions from more efficient flight operations would be more than adequate to pay for it several times over. The depressing reality is that, as of today, we're going absolutely nowhere fast – just like our customers.

Any increase in NERL charges above the basic rate of inflation must be linked directly to a set of clear objectives on airspace modernisation; if these are not achieved, airspace users should be afforded rebates in direct proportion to the inefficiency to which they have been subjected in flight operations.

Relativity of NERL charges to other European countries

Eurocontrol's December 2022 data shows that the UK's ATS unit rates are in the top ten of 41 Eurocontrol member regions – and if the 27% increase is applied, *ceteris paribus*, the UK will rise to become the third most expensive state, surpassed only by Belgium and Switzerland, which both have notoriously high labour and social costs. Major European countries including Germany, Spain, Ireland and Greece – which have similar mix of transit and point-to-point airspace users - have charging rates below the UK's current levels.

Even so, the relevance of these to Loganair's business and its customers is irrelevant. The CRCO charging rates in Belgium or Switzerland aren't relevant to our passengers. The rates for use of UK airspace are, for they directly impact fares that the consumer has to pay for economically sustainable air travel within the UK.

Impact on the proposals on UK regional connectivity

We estimate that the NERL charging proposals, if upheld by the CAA, will result in an increase in costs to Loganair of approximately £900,000 per year.

A substantive problem for airlines such as Loganair is that we are, in effect, a "captive market". Airlines overflying the UK or entering and exiting UK airspace can readily adjust their routings to reduce, or in many cases eliminate, their exposure to increased UK ATS charges. Many already do – hence why flights from the UK to the Canary Islands often leave UK airspace early and take routings into Irish airspace (where ATS unit rates are 57% lower than the UK's) and then oceanic routings south.

To be clear, we have no such alternatives. Turning south-west after take-off and flying via cheap Santa Maria airspace to get from Edinburgh to Stornoway is not an option for Loganair. The brunt of the NERL 27% increases will fall on domestic air travellers, and the likely consequence of a material increase in the UK's ATS unit charging rates will be to drive other carriers away from UK airspace where they have a choice; the pure scale of the increase will lead to a law of diminishing marginal revenue returns for NERL.

The UK Government has made much of its "levelling up" agenda, and the change to UK Air Passenger Duty on domestic flights from April 2023 is designed to maintain and foster air connectivity throughout the UK. Heathrow Airport has also reformed its charges, from January 2023, to recognise the value of UK domestic connectivity. The NERl charging proposals seem to be intent on wiping out these benefits, and our view is that the CAA cannot be complicit in allowing this to happen.

Regional connectivity will be reduced as marginal routes will become unviable – and in a country where 60% of domestic flights cross water, this is a substantive issue in which the CAA must take a direct interest when determining the regulatory regime under which NERL operates.

In order to address this inequality, we wish to propose a UK Regional Connectivity scheme to be mandated within the charges settlement for NERL. This would draw directly upon the UK Government's recent 50% cut in Air Passenger Duty for domestic flights, implemented upon the recommendations of Sir Peter Hendy's Union Connectivity Review.

To replicate this within the ATS structure, for aircraft engaged in commercial air transport operations where the departure and arrival point of the flight is within the UK, the weight-related element of the NERL charges should be reduced by 50%. In effect, an aircraft such as an ATR72 of 23 tonnes MTOW on a purely domestic flight would be charged at an 11.5-tonne MTOW and an aircraft such as an Airbus A320 of 73.5 tonnes would be charged at 36.75 tonnes.

Given the limited number of operators engaged in pure UK domestic activity, this could readily be administered via a monthly credit note, and the issue of that credit note could be contingent upon timely settlement of the individual operator's standard Eurocontrol invoice, further helping NERL to manage its bad debt provisions.

We believe that there is considerable merit in such a proposal, and that this would ensure that both the CAA and NERL are aligned with the UK Government's wider objectives to maintain UK regional air connectivity. If the charging proposals are implemented without any such safeguards for UK domestic flights, the conflicting approach in policy will lay all parties open to justifiable criticism around the disjointed approach to Union Connectivity.

Conclusions

We trust that the rationale for our proposals is clear from this letter, and reiterate our strong opposition to any above-inflation increase in NERL charges unless this is aligned to delivery of airspace modernisation programmes and contains adequate safeguards for UK regional air connectivity.

Should the CAA wish to discuss this further with Loganair, we would be only too pleased to meet with its representatives and/or to attend a session at a mutually convenient time between the CAA and NERL to ensure that our viewpoint may be properly conveyed and understood. As the UK's largest regional airline, Loganair has a keen interest in the matter at hand, and we believe it is essential for us to take an active role in defending the wider interests of our passengers who are dependent upon the UK domestic air connectivity that we provide.

Yours sincerely,

Jonathan Hinkles
Chief Executive