Our business

Who we are

NATS Holdings Limited (NATS) is an air traffic control (ATC) services provider which owns two principal operating subsidiaries: NATS (En Route) plc and NATS (Services) Limited.

NATS (En Route) plc (NERL) is our core business and the sole provider of ATC services for aircraft flying 'en route' in UK airspace and the eastern part of the North Atlantic. It is regulated by the Civil Aviation Authority (CAA) within the framework of the European Commission's (EC) Single European Sky (SES) and operates under licence from the Secretary of State for Transport. It operates from two ATC centres; Swanwick in Hampshire and Prestwick in Ayrshire.

NATS (Services) Limited (NATS Services) provides ATC at 14[1] UK airports, and to Gibraltar and three other airfields under the UK MOD's Project Marshall contract. It also provides engineering, consultancy (including training) and aviation information management services to UK and overseas customers and to the UK MOD. FerroNATS, a joint venture with Ferrovial Servicios SA, provides air traffic services at 9 airports in Spain. Aquila, a joint venture with Thales UK Limited, is fulfilling the Project Marshall[2] contract.

Our purpose

We keep the skies safe and deliver the best possible customer experience.

Our objectives

- Delivering a safe, efficient and reliable service every day.
- Delivering SESAR[3] and transforming the business for the future.
- Winning and retaining commercial business.

[1] All references are provided on page 150 of this report

Highlights

Financial highlights

Financial year ended 31 March (£m unless otherwise specified)	**2016**	2015	Change %
Revenue	**898.1**	922.4	-2.6
Profit before tax, goodwill impairment & exceptional redundancy costs (in 2015)	**137.1**	226.5	-39.5
Profit before tax	**44.4**	200.3	-77.8
Capital expenditure	**147.6**	153.5	-3.8
Net debt[1]	**303.3**	378.7	-19.9
Gearing[2]	**49.1%**	53.4%	-8.1
Dividends	**81.7**	77.0	+6.1

[1] Excludes derivative financial instruments
[2] Ratio of the net debt to regulatory assets of the economically regulated business (NERL)

Delivering a safe, efficient and reliable service

- We handled 2.3 million flights (2015: 2.2 million) and maintained our safety record. Average en route delay per flight was 4.3 seconds (2015: 2.2 seconds).
- We are enabling annual emissions savings of 1.1 million tonnes of CO_2 (34,000 tonnes more than in 2015), worth around £111m in fuel savings to airline customers.
- We took over the ATC for two military airfields and upgraded radio and tower systems at a number of MOD sites in support of Aquila's Project Marshall contract.

Delivering SESAR and transforming the business

- We have a clear technical and operational transition programme to integrate and deploy SESAR technology.
- Milestones we completed included the transition to the temporary operations room at Swanwick and starting to use our new flight data processing system (iTEC[4]) in the Scottish Flight Information Region.

Winning and retaining commercial business

- We renewed ATC contracts with Aberdeen, Belfast International, Glasgow, Heathrow and Southampton. We were awarded the ATC contract by George Best Belfast City Airport.
- The Gatwick ATC service was smoothly transferred to a new provider.
- We deployed Time-Based Separation (TBS) at Heathrow airport, significantly enhancing performance on the windiest days.
- We grew our international business.

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For best results when using an iPad, open the PDF then tap on it in your browser window and choose 'Open in...' from the pop-up menu bar, then 'Adobe Reader' from the drop-down panel. (Get Adobe Acrobat free from the App Store.)

Strategic Report

Chairman's statement

Financial performance

Calendar year 2015 was the first full year of Regulatory Reference Period 2 (RP2: 2015 to 2019). As foreshadowed in last year's report, the results this year reflect the challenging regulatory settlement for RP2 and the more competitive environment for our airport ATC business. Our results show reduced revenues of £898m (2015: £922m) and a significantly lower profit before tax of £44m (2015: £200m), after anticipated increases in pension and depreciation charges, and a £93m (2015: £17m) goodwill impairment charge. Our cost base has been progressively reduced in anticipation of the lower revenues we now face, enabling NATS (En Route) plc (NERL) to achieve a modest outperformance of its regulatory rate of return in the first year of RP2.

In May 2016, the company paid a first interim dividend for 2016/17 of £24.0m which mainly reflects a proportion of the allowance for shareholder return that the CAA made in the prices that NERL is permitted to charge in RP2. The company paid dividends of £81.7m during the 2015/16 financial year which also reflected some dividends from accumulated retained earnings not distributed in earlier regulatory reference periods, noting that NERL paid no dividends to shareholders from the date of the PPP until October 2008.

Safety and operations

We have maintained our excellent safety record, providing a resilient service with little air traffic delay and achieved a number of important capital investment milestones. I am pleased to report that a number of airport operators awarded their tower contracts to NATS this year. We also transitioned air traffic control operations smoothly to the new provider at Gatwick airport.

Our strategic objectives

Our direction is now very clear as we progress through RP2:

- deliver a safe, efficient and reliable service from our air traffic control centres and airport towers;
- transform the business through the integration and deployment of Single European Sky ATM Research programme (SESAR) technologies; and
- win and retain commercial UK business and explore sound international opportunities as they arise.

The most far reaching objective is deploying SESAR technology to improve the way Europe's airspace is managed. We have a clear technical and operational transition plan and have started to deliver this challenging and major programme of work.

Independent Enquiry actions

We have discharged the 21 NATS related recommendations resulting from the Independent Enquiry into the December 2014 technical failure at Swanwick. In addition, we are working with the CAA on the five joint recommendations which are expected to complete in 2017, subject to stakeholder consultation.

Chairman's statement
(continued)

EU referendum

During the year the Board considered how the referendum on continued United Kingdom (UK) membership of the European Union (EU) will affect the Company. If the UK votes to remain in a reformed EU, we do not anticipate a significant impact on NATS activities or business risks from the changes agreed with EU partners. If the UK votes to leave the EU then, in the longer-term, the impact of this decision depends to a large extent on the type of relationship that is forged between the UK and the EU. However, we do not expect that it will have a significant impact on NATS activities provided the UK continues to participate in the Single European Sky project (SES). However, in the shorter-term the initial uncertainty and market volatility that might result (e.g. exchange rates) could affect the demand for air travel and therefore our future revenue, although any changes would be mitigated by traffic volume risk sharing arrangements.

Defined benefit pension scheme

Trustees of the defined benefit pension scheme are performing their formal triennial valuation as at 31 December 2015. The funding position is likely to show a materially higher deficit than the last valuation due to continued challenging market conditions. Actions are in place, through the economic regulatory framework and from cash reserves to enable the company to meet likely increases in contributions. The Trustees are expected to complete their valuation later this year.

HM Government's shareholding

In his Autumn Statement, the Chancellor of the Exchequer announced that HM Government would explore the sale of its 49% shareholding in NATS. The Board is being kept informed of this review, but understand that no final decision has yet been made.

Governance

In October, the Board confirmed Martin Rolfe's appointment as Chief Executive Officer after a rigorous search involving internal and external candidates. Since his appointment he has set a new tone with employees, customers and other external stakeholders.

Derek Provan joined the Board this year and brings the benefit of his experience of airfield operations at Heathrow. He replaced Roger Cato who stood down after serving for 13 years. I would like to thank Roger for his valuable contributions to the Board, Safety Review, Technical Review and Nomination committees.

Outlook for 2017

We knew that RP2 would bring challenges. Our regulatory targets for 2017 are even more demanding than for 2016. Traffic volumes are growing, which is positive but also presents a challenge in terms of airspace capacity and society's tolerance for overflight noise. We will seek to improve how we engage with the range of stakeholder views and seek to address them as we make our case for airspace modernisation. We also remain acutely aware that we are not the only choice of air traffic service provision for UK airports and will continue to strive to provide the safest and most efficient service possible to all customers.

NATS is well equipped to meet these challenges.

I would like to extend my appreciation to the management team and all of our employees for their hard work and commitment to the company's success.

Dr Paul Golby, CBE,
Chairman


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Chief Executive's review

This has been a year of many firsts: the first full year of RP2; the first year of implementing our SESAR deployment strategy; and the first year of our strategic partnership with Heathrow. It is also the end of my first year as Chief Executive Officer, with my new management structure now in place.

Overview of performance

We expected our profitability to be lower this year for the reasons given by the Chairman. We therefore took the right actions over the last two years to reduce costs.

Last summer I set out our priorities for the year (see table below). I am pleased to report that we achieved most of these.

We handled 2.28 million flights in the year, 3% more than 2015. This was another very safe year for our ATC provision with no risk-bearing Airprox[5] incident attributable to NATS. Overall we performed better than 2013 but not quite as well as 2014 which was a particularly good year. We continue to look for ways to reduce safety risk and introduced measures over the winter which improved our safety performance at airports. Benchmarking against our peers confirms we are meeting, and in some cases setting, best practice.

Unauthorised infringements of controlled airspace account for about 30% of NATS safety risk and we are actively working with the CAA and the Airport Operators Association (AOA) to tackle hotspots around key airfields. While good progress has been made engaging with the general aviation community, this has not achieved the level of improvement we believe is essential. We have worked with the CAA to establish an approach which includes tougher CAA enforcement action against repeat offenders and increased funding for tools and technology to detect infringers and to support pilots, including their training. We also see a need for a greater focus on drones, including technical solutions to assist detection, alongside a regulatory policy that recognises their increased use for commercial and recreational purposes.

Our overall, Air Traffic Flow Management (ATFM) delay[6] for the financial year was 4.3 seconds per flight (2015: 2.2 seconds). While this is marginally higher than last year it is seven times better than the European average. A significant contributor to our good performance this year has been Time-Based Separation (TBS). NATS deployment of this capability is a world first, and has improved landing rates at Heathrow airport in conditions of strong headwinds, significantly enhancing performance during some of the windiest days. It has fundamentally, and safely, changed the management of airport approach and won several industry awards in its first year of operation. Our primary objective will always be keeping the skies safe while delivering the best possible service – this means ensuring that we employ the best technology that we can. Our ambition for our regulated business is to provide our customers 'One Operation from Two Centres on a Common Platform'. This will enable us to replace our legacy systems with new technology that is easier and more cost effective to maintain, allowing us to be more agile and responsive to customer needs. SESAR technology will also enable us to increase our airspace capacity to accommodate rising traffic levels and interoperate fully

Chief Executive's review
(continued)

Priorities for 2015/16	How we did
Safety & resilience: Continue to provide safe and resilient air traffic services from our 14 UK airports and two en route centres.	✓
Temporary Operations room: Transition to the temporary operations room in Swanwick, the first stage of the SESAR deployment plan.	✓
iTEC: Deploy and operate iTEC in the Scottish upper airspace.	✓
Airport contracts: Renew or win three or more UK airport contracts.	✓
Project Marshall: Start the Marshall Programme ATC and technical services at Middle Wallop/Netheravon & Shawbury.	✓
Overseas revenue: Achieve overseas revenue target in our focus regions.	✗

with other European ANSPs. This year we developed the transition sequence for deploying SESAR technology. We achieved the first milestone by moving the Swanwick area control and military operations into a temporary operations room while we refit the main operations room. The second major milestone was achieved with iTEC entering limited service for Scottish upper airspace, a clear step towards trajectory-based operations (more accurate and dynamic flight profiles coordinated between stakeholders).

In service of the UK's aviation strategy, we delivered the first stage of our airspace modernisation programme (LAMP[7] phase 1a) but further stages have been paused. The pace of progress now depends on the political will to support its wider benefits. Airspace change is a challenge for the aviation industry, particularly in the face of concerns about aircraft noise and pending the decision on runway capacity in the South East. We are investing heavily in engaging with local communities most likely to be impacted by airspace change to try to find the best solutions for local communities, airlines, the travelling public and NATS.

We are working hard to make our airport service proposition even more compelling. This was reflected in important contract renewals from Aberdeen, Belfast International, Glasgow, Heathrow and Southampton, and the winning of George Best Belfast City Airport.

Edinburgh airport is tendering its next ATC contract, which we will be competing to retain. We also supported Gatwick airport with the transition of its ATC service to its new provider, and have seconded NATS staff to support that service.

Our support to Project Marshall, awarded in 2014 by the MOD to Aquila, our joint venture with Thales UK, has started positively. We now provide the ATC service at Middle Wallop and Netheravon airfields and are upgrading and maintaining radio and tower systems at a number of MOD sites.

In Europe, our FerroNATS joint venture handles 20% of Spanish airport air traffic movements and is meeting all of its operational performance targets. We are continuing to develop our other international business and this year generated revenue of £7.6m (2015: £4.1m). The Asia Pacific region performed a little better than expected while the lower oil price has reduced opportunities in the Middle East for now.

Our purpose and objectives

Since taking over as CEO and following my engagement with some 2,000 staff last summer, it was clear that a more engaging and effective articulation of our purpose and strategic objectives was necessary. I am now working with my executive team to achieve this. Our strategic objectives are clear, my executive team is focused on delivering our day to day operations, delivering the SESAR technology and related business change; and winning and retaining commercial business.

Our priorities for 2017

- Provide safe and resilient air traffic services from our airports and centres.
- Achieving two SESAR milestones: to complete the introduction of iTEC into Scottish upper airspace; and to deploy and operate electronic flight strips in limited operational service in Swanwick Terminal Control.
- Achieve a Mode-S Surveillance radar capability for Project Marshall.
- Establish a remote tower capability for airport ATC operations.
- Establish further strategic partnerships with our airport customers.

Overall, we made good progress in meeting our objectives in 2015/16 which gives me further confidence that we can rise to the challenges we face as we transform the business in RP2. Above all, I would like to thank all our employees for their dedication again this year.

Martin Rolfe
Chief Executive Officer

Financial review

Financial year ended 31 March	2016	2015
	£m	£m
Revenue	898.1	922.4
Profit before tax, goodwill impairment & exceptional redundancy costs (in 2015)	137.1	226.5
Profit before tax	44.4	200.3
Profit after tax	27.6	156.9
Dividends	81.7	77.0

The group reported a profit before tax of £44.4m compared with £200.3m in 2015. Profit before tax and goodwill impairment was £137.1m (2015: £226.5m before tax, goodwill impairment, and exceptional redundancy costs). A reduction in revenue and profit was signalled in last year's annual report, which referenced the impact of lower prices for UK en route and airports services, higher accounting pension costs and depreciation charges. The factors impacting the results are as follows:

		Profit before tax
	£m	£m
2015 profit before tax		200.3
Revenue changes		
Airspace		
UK en route revenue	(32.2)	
Service performance incentive	(1.1)	
Other revenue changes (net)	7.0	
	(26.3)	
Airports	(15.3)	
Engineering	14.6	
Other UK business	(0.8)	
International	3.5	
		(24.3)
Operating cost changes		
Staff pension costs	(30.5)	
Other staff costs	(4.8)	
Non-staff costs (net of other income)	(20.2)	
Depreciation & amortisation, net of grants	(18.5)	
Disposal of assets	7.3	
		(66.7)
Goodwill impairment	(75.7)	
Exceptional redundancy costs	9.2	
		(66.5)
Finance cost changes		
Fair value movement on derivative contract		1.1
Results of associates & joint ventures		0.5
2016 profit before tax		**44.4**

Financial review
(continued)

Regulatory return

We assess the performance of NERL's regulated activities by reference to the regulatory settlement. For the first year of RP2 (calendar year 2015), NERL achieved a pre-tax real return of 6.94% compared with the regulatory return of 5.86% assumed in the regulatory settlement. This was mainly achieved through service performance incentives and operating cost efficiencies which offset a lower rate of traffic volume increase than previously assumed.

While this is a good start to the reference period, the modest outperformance from service incentives and cost efficiencies will be challenging to maintain. We expect traffic volumes to continue to grow at a time when we will be deploying SESAR through RP2, which will put pressure on service performance. We will also bear the costs of running legacy systems during the period of transition to SESAR technology.

Comparison between reported profit and regulatory return

The profits reported in these financial statements are prepared in accordance with IFRS and policies described in note 2 to these accounts. As described below, the CAA applies an economic regulatory building block model which is mainly cash-based. It can give rise to some significant differences between reported operating profit and regulatory return, mainly due to:

- lower historical cost depreciation compared with regulatory depreciation which is indexed to inflation; and
- lower accounting pension costs using best estimate assumptions prescribed by accounting standards compared with cash contributions agreed with Trustees, which include a margin for prudence.

This difference in basis explains why NERL's reported operating profit before goodwill impairment is some £67m higher than its regulatory profit, on the calendar year basis reported for its regulatory accounts.

Revenue

Revenue at £898.1m (2015: £922.4m) was £24.3m lower. This included a full year's impact of the RP2 settlement, which applied from January 2015. UK en route revenue was lower by £32.2m as regulatory allowances reflected the CAA's challenging cost efficiency targets and a lower cost of capital in RP2. Revenue from UK airport ATC services was also lower by £15.3m reflecting price reductions and the loss of the Birmingham and Gatwick contracts.

These reductions were partly offset by growth in engineering income, largely from work performed for our Aquila joint venture's Project Marshall contract. Revenue from our contract with the MOD and from European organisations also improved.

Operating costs

Operating costs, before goodwill impairment, as well as exceptional redundancy costs in 2015, were £736.3m (2015: £669.6m).

The increase in staff costs was largely due to higher pension charges. Before redundancy-related past service costs, these were £30.5m higher at £140.6m (2015: £110.1m) principally due to an increase in the accrual rate for the defined benefit pension scheme to 45.4% (2015: 32.5%), before salary sacrifice.

	2016	2015
	£m	£m
Staff costs	**(439.1)**	(403.8)
Non-staff costs	**(176.3)**	(156.1)
Asset related charges	**(128.0)**	(109.5)
Profit/(loss) on disposal of assets	**7.1**	(0.2)
Operating costs	**(736.3)**	(669.6)

The average number of staff employed during the year was 4,164 (2015: 4,342) and those in post at 31 March 2016 decreased by 2.5% to 4,144 (2015: 4,252).

Non-staff costs (net) at £176.3m (2015: £156.1m) were £20.2m higher than the previous year. This mainly reflects the increase in activity to support Project Marshall and SESAR deployment. It also includes some property charges from airport operators this year, which are charged back to them through our ATC contract. The company also relocated staff following the closure of its office near Heathrow.

Financial review
(continued)

Asset related charges (net), mainly depreciation and amortisation, increased to £128.0m (2015: £109.5m): during 2015 we re-assessed the remaining economic lives of some assets to reflect the timing of deployment of SESAR technology. The profit for the year also included gains of £7.1m from asset disposals (2015: loss £0.2m).

Goodwill impairment and exceptional redundancy costs (in 2015)

	2016	2015
	£m	£m
Goodwill impairment	**(92.7)**	(17.0)
Exceptional redundancy costs	**-**	(9.2)
Total before tax	**(92.7)**	(26.2)

A goodwill impairment charge of £92.7m was recognised this year (2015: £17.0m) by NERL, our economically regulated business. It does not impact its cash flows or its regulatory profit. The impairment charge reflects an assessment of: opportunities to outperform regulatory targets in RP2; our assessment of any potential premium that a purchaser might pay for a controlling interest; our latest forecasts of traffic volumes relative to the RP2 settlement; and our ability to recover true-ups in relation to certain regulatory revenue allowances (e.g. pension costs).

The carrying value of goodwill is intrinsically linked to NERL's regulatory settlements and its Regulatory Asset Base (RAB) in particular. NERL's RAB is uplifted annually for inflation and increases with capital expenditure and reduces by regulatory depreciation. Regulatory depreciation is a source of revenue allowances (explained in the description of NERL's business model). During RP2, NERL's capital investment is projected to be less than regulatory depreciation. As a result, the RAB is expected to contract in real terms.

Consideration is also given to opportunities to outperform regulatory settlements and any premium which a purchaser would be willing to pay for a controlling interest by reference to the projected financial return indicated by the company's business plan and UK and European market transactions in utilities and airport operators.

One-off redundancy costs of £9.2m were incurred in 2015 by NATS Services as it reorganised its activities to improve its competitiveness.

Share of results of joint ventures and associates

	Total	**2016 Group's share**	Total	2015 Group's share
	£m	**£m**	£m	£m
Turnover				
FerroNATS	**9.7**	**4.9**	10.4	5.2
Aquila	**74.4**	**37.2**	28.0	14.0
ESSP	**47.7**	**8.0**	49.7	8.3
	131.8	**50.1**	88.1	27.5
Profit after tax				
FerroNATS	**1.1**	**0.6**	0.9	0.5
Aquila	**0.9**	**0.5**	0.3	0.1
ESSP	**2.7**	**0.4**	2.1	0.4
	4.7	**1.5**	3.3	1.0
Net assets				
FerroNATS	**3.3**	**1.7**	2.0	1.0
Aquila	**1.5**	**0.7**	0.5	0.2
ESSP	**7.4**	**1.2**	5.2	0.9
	12.2	**3.6**	7.7	2.1

The group recognised £1.5m (2015: £1.0m) for its share of the post-tax profits of its two joint ventures: FerroNATS and Aquila, and its associate European Satellite Services Provider SAS (ESSP). FerroNATS has performed broadly in line with the previous year while Aquila, which was established for the Project Marshall contract it won in the previous year, has now started to upgrade the MOD's ATC infrastructure.

Financial review
(continued)

Net finance costs

Overall, net finance costs of £26.2m were £1.1m less than the prior year (2015: £27.3m) and mainly reflected the change in market value of the index-linked swap derivative contract.

The swap was taken out in 2003 as an economic hedge of NERL's revenue allowance for financing charges, which is linked to inflation. It does not qualify for hedge accounting under international accounting standards, and changes in its fair value are recognised in the income statement. The fair value varies with changes in the market's expectations of inflation and swap discount rates over the time to expiry of the contract in 2026, and can be volatile. This year, changes in market conditions resulted in a slightly greater reduction in the swap's market value liability than the prior year, resulting in a credit of £2.6m (2015: £1.5m credit).

Excluding the swap, net finance costs were unchanged at £28.8m (2015: £28.8m). The benefit of lower bond interest following repayments of bond principal was offset by the cost of refinancing bank facilities and lower interest earned on cash balances.

Taxation

The tax charge of £16.8m (2015: £43.4m) was at an effective rate of 37.8% (2015: 21.7%). This is higher than the headline rate of 20%, mainly reflecting the goodwill impairment charge, which is not tax deductible, partly offset by the deferred tax impact of the reduction in the corporation tax rate to 18% from April 2020. The further reduction to 17%, announced in the March 2016 Budget, will not be recognised until Finance Bill 2016 has been substantially enacted.

NATS' taxes generally arise in the UK, though it undertakes business in other countries. Wherever we operate we organise our operations to pay the correct and appropriate amount of tax at the right time, according to relevant national laws, and ensure compliance with the group's tax policies and guidelines.

During the year the company paid UK corporation tax of £29.8m (2015: £34.6m) and foreign tax of £0.6m (2015: £0.1m). The company also pays other taxes such as employer's national insurance contributions and business rates, a significant cost each year.

The group's tax strategy is reviewed annually by our Tax Committee and covers the application of all direct and indirect taxes to our business including corporation tax, payroll taxes and value added tax. The Tax Committee reports to the Audit Committee and comprises the Finance Director, the Head of Tax and other senior finance professionals and takes advice from a professional firm.

We have a positive working relationship with HM Revenue & Customs (HMRC) and we are committed to transparency in all tax matters. This includes annual meetings with HMRC to review the group's performance and its business strategy.

Dividends

In May 2016, the company paid a first interim dividend of £24.0m which mainly reflects a proportion of the allowance for shareholder return that the CAA made in the prices that NERL is permitted to charge in RP2. The company paid dividends of £81.7m during the 2015/16 financial year which also reflected some dividends from accumulated retained earnings not distributed in earlier regulatory reference periods, noting that NERL paid no dividends to shareholders from the date of the PPP until October 2008.

Balance sheet

The change in financial position since the start of the year reflects an improvement in the accounting measurement of the defined benefit pension scheme IAS19 funding position (net of related deferred tax), capital investment and retained earnings. These, as well as movements in cash, borrowings and derivatives, are explained in this review.

	2016	2015
	£m	£m
Goodwill	**209.3**	302.0
Tangible and intangible fixed assets	**994.5**	977.3
Other non-current assets	**29.0**	67.4
Cash and short term deposits	**257.1**	267.0
Derivatives (net)	**(128.3)**	(128.6)
Pension scheme deficit	**(77.4)**	(353.0)
Borrowings	**(560.4)**	(645.7)
Deferred tax liability	**(70.5)**	(19.2)
Other net liabilities	**(39.5)**	(33.5)
Net assets	**613.8**	433.7

Financial review
(continued)

Capital investment

	2016	2015
	£m	£m
SESAR Deployment	80.7	51.5
Airspace	8.6	18.0
Infrastructure	15.1	26.3
Operational systems	19.7	32.6
Other	10.8	13.0
Regulatory capex	**134.9**	141.4
Military systems	4.2	6.1
Other non-regulatory capex	8.5	6.0
Capital investment	**147.6**	153.5

We plan to invest £575m (in 2012 prices) in our regulatory assets during RP2 and we spent £134.9m (2015: £141.4m) in 2016. This included investment in the following priorities: the temporary operations room at Swanwick, the delivery of iTEC into service in Scottish upper airspace, both part of SESAR deployment, airspace modernisation (LAMP phase 1a) and an enhanced data and voice communications network.

A focus of our strategy is to accelerate the delivery of new SESAR technology while reducing investment in legacy systems in order to improve cost efficiency and enable greater customer benefit sooner.

Defined benefit pensions

Most staff still benefit from a final salary defined benefit scheme (the NATS Section of the CAA Pension Scheme or CAAPS). It was closed to new members in 2009 but has 3,324 active members, 2,413 pensioners and 1,189 deferred members. Staff who are not members of this scheme are able to benefit from a defined contribution scheme. More information on our pension arrangements and their governance is provided in note 30 to the consolidated financial statements.

a. Accounting position under IAS19

At 31 March 2016, measured under international accounting standards and the associated best estimate assumptions, the defined benefit scheme was in deficit with liabilities (£4,760.0m) exceeding assets (£4,682.6m) by £77.4m (2015: £353.0m).

Defined benefit scheme liability	£m
At 1 April 2015	(353.0)
Charge to income statement	(132.7)
Actuarial gains/(losses):	
- on scheme assets	(140.1)
- on scheme liabilities	428.1
Employer contributions*	120.3
At 31 March 2016	(77.4)
Represented by:	
Scheme assets	4,682.6
Scheme liabilities	(4,760.0)
Deficit	(77.4)

* including salary sacrifice

Given the size of the scheme relative to the group, changes in market conditions can have relatively large impacts on the results and financial position. The IAS19 accounting standard requires discount rates for valuing pension obligations to be based on AA corporate bonds. Since 2015 the yield (in real terms) on these has increased by 35 basis points, leading to a corresponding reduction in pension liabilities. Asset values were broadly unchanged from the prior year.

b. Funding valuation and future funding obligations

The funding of the defined benefit scheme is subject to agreement between the company and the scheme's Trustees and is determined based on the conclusion of each triennial valuation conducted by the Trustee. This valuation uses a wide range of assumptions for measuring pension liabilities and legislation requires a margin for prudence. As a result the triennial valuation gives rise to a different valuation than that disclosed under international accounting standards.

The last triennial valuation was as at 31 December 2012 and reported a deficit of £382.6m. The contributions agreed with Trustees included an 11-year deficit recovery plan requiring payments of £26.6m in the 2014, £28.6m in the 2015 and £29.3m in the 2016 calendar years. In addition, future service contributions were paid at a rate of 36.7% of pensionable pay (excluding salary sacrifice) until 1 January 2015 when these reduced to 29.4%, reflecting the cap on pensionable pay rises and the Trustees' decision to move to CPI-linked indexation of future service from 1 November 2013.

Financial review
(continued)

Overall, excluding salary sacrifice contributions of £14.7m (2015: £15.2m) and redundancy past service costs for the defined benefit scheme of £0.8m (2015: £2.2m), the group's contributions in this financial year of £104.8m (2015: £121.3m) represented 41% of pensionable pay (2015: 45%).

The Trustees are now undertaking their next triennial valuation as at 31 December 2015 and are expected to complete this in the final calendar quarter of 2016. The company expects that this will report a materially larger deficit compared with the results of the 31 December 2012 triennial valuation and the accounting basis for measuring the funding position in our accounts. This will lead to higher pension contributions in RP2 which the group has adequate resources to finance and which are taken into account in dividend distribution policies.

Net debt

	Cash and short-term investments	Borrowings	Net debt
	£m	£m	£m
Balance at 31 March 2015	267.0	(645.7)	(378.7)
Cash flow	(9.2)	89.3	80.1
Short-term deposits	(0.8)	-	(0.8)
Non-cash movements	0.1	(4.0)	(3.9)
Balance at 31 March 2016	**257.1**	**(560.4)**	**(303.3)**

During the year we refinanced NERL's bank facilities to provide committed funding throughout RP2 (2015 – 2019). NERL agreed facilities of £400m, £125m more than previously, with an initial maturity date of 31 July 2020 with an option for extending these arrangements for a further two years (i.e. to 31 July 2022). At 31 March 2016, NERL had drawn £95.0m or 24%, leaving significant headroom should further drawings be required. In addition to this bank facility NERL has a bond with a balance of £467.4m at the year end (2015: £498.0m). More information is provided in note 17 to the consolidated financial statements.

At 31 March 2016, borrowings were £560.4m (2015: £645.7m) and cash and investments decreased to £257.1m (2015: £267.0m). Net debt decreased by £75.4m to £303.3m (2015: £378.7m).

Financial review
(continued)

Cash flow

Cash and cash equivalents decreased by £9.1m to £228.2m (2015: £237.3m).

	2016	2015
	£m	£m
Net cash from operating activities	**341.7**	283.8
Net cash used in investing activities	**(148.8)**	(145.9)
Net cash used in financing activities	**(202.1)**	(112.2)
(Decrease)/increase in cash and cash equivalents[1]	**(9.1)**	25.7
Cash and cash equivalents at end of year	**228.2**	237.3

[1] Including exchange of £0.1m

Net cash from operating activities was £341.7m (2015: £283.8m). This increase in cash flow reflected lower future service contributions to the defined benefit pension scheme from 1 January 2015 (reflecting the cap on pensionable pay rises and the Trustees' decision to move to CPI-linked indexation of future service), lower redundancy payments, higher customer receipts and less tax and operating expenditure. Cash from operations helped the group to finance its capital investment and to service debt obligations. The group repaid bond principal of £30.8m and lowered drawn bank facilities by £56.6m.

Outlook for 2017

We expect our revenue next year to be broadly in line with 2016, with increased revenue from flights and our contract with Aquila offsetting further price reductions and the loss of airport ATC contract income. We also expect earnings before interest, tax, depreciation and amortisation to be broadly stable.

Nigel Fotherby
Finance Director

Going concern and Viability statements

Going concern

The group's business activities, together with the factors likely to affect its performance and financial position, its cash flows, liquidity position and borrowings are set out in the review above.

In addition, note 19 to the financial statements describes the group's objectives, policies and processes for managing its capital and its financial risks; and details its financial instruments and hedging activities.

At 31 March 2016, the group had cash of £257.1m and access to undrawn committed bank facilities of £305.0m that are available until July 2020. The group's forecasts and projections, which reflect its expectations for RP2 and taking account of reasonably possible changes in trading performance, show that the group should be able to operate within the level of its existing facilities for the foreseeable future. The UK en route business also benefits from some protections against traffic volume risk afforded by its price control conditions. Other sources of income are generated mainly from long term contracts, some of which were renewed in the year. As a result, the directors believe that the group is well placed to manage its business risks.

The directors have formed a judgement that, taking into account the financial resources available, the group has adequate resources to continue to operate for a period of at least twelve months from the date of approval of the financial statements, and have therefore adopted the going concern basis in the preparation of the financial statements.

Viability statement

In accordance with provision C.2.2. of the UK Corporate Governance Code, the directors have assessed NATS viability over the three years ending 31 March 2019. This is based on three years of the group's business plan and represents a period for which there is greater certainty over forecasting assumptions. The business plan is updated annually and reflects the group's strategy and its financial plans.

The assessment of viability has been made with reference to NATS current position and future prospects, its business strategy and available financial resources. Specific consideration has been given to the outlook for en route air traffic volumes, the terms of the group's airport ATC contracts, including their length, and their renewal prospects, and expected contributions to the defined benefit pension scheme which will be based on the valuation as at 31 December 2015 to be completed by Trustees in the last quarter of 2016.

The directors also assessed the potential financial and operational impacts in plausible downside scenarios of the principal risks and uncertainties set out on page 32 and the effectiveness of currently available mitigating actions. Based on this assessment, the directors have a reasonable expectation that NATS will be able to continue in operation and meet liabilities falling due up to 31 March 2019.

In making this statement the directors have also assumed that the impact of the 23 June 2016 UK referendum decision on the European Union will not have a material adverse impact on the company's operating and financial performance over the period of assessment.

Key performance indicators

We adopt a number of financial and non-financial Key Performance Indicators (KPIs) that enable us to track progress against our business plan objectives and which are relevant to the different activities of our principal operating subsidiaries: NERL and NATS Services. For NERL, KPIs are largely aligned with the Single European Sky (SES) key performance areas ensuring management focus on meeting safety, service quality, environmental and cost efficiency targets. For NATS Services, the focus of management is on safety, customer service and on growing the business profitably. A number of the metrics are also used to set targets for remuneration purposes and so align incentives with business objectives.

NATS' actual performance relating to financial and non-financial KPIs

Description	Financial year 2016 or calendar year 2015	Financial year 2015 or calendar year 2014
Financial KPIs		
Profit before tax: NATS Group	£44.4m	£200.3m
NERL	£22.4m	£172.7m
NATS Services	£22.3m	£27.9m
Non-financial KPIs		
Safety performance:		
NATS Group: category A or B Airprox[5] attributable to NATS (financial year)	nil	1
Calendar year metrics:		
NATS Group KPI: RAT[8] points (12 month rolling)	1,497	1,099
NERL KPI: RAT points (per 100,000 flights, 12 month average)	38.3	29.4
NATS Services KPI: RAT points (per 100,000 flights, 12 month average)	34.5	22.7
Service performance & resilience:		
NATS Group: customer satisfaction score	85%	84%
NERL KPIs		
Average delay (seconds per flight, financial year)	4.3	2.2
Average delay (seconds per flight, calendar year)	2.4	2.2
Impact score[9] (weighted seconds per flight, calendar year)	5.2	4.2
Variability score[10] (weighted seconds per flight, calendar year)	14.2	195.2
3Di[11] score (calendar year)	30.1	29.8 (restated)
Environmental performance (financial year):		
NATS Group KPI: enabled fuel CO_2 reduction (cumulative % vs 2006 baseline)	4.3%	4.2% (restated)

Safety, regulatory and economic environment

Safety

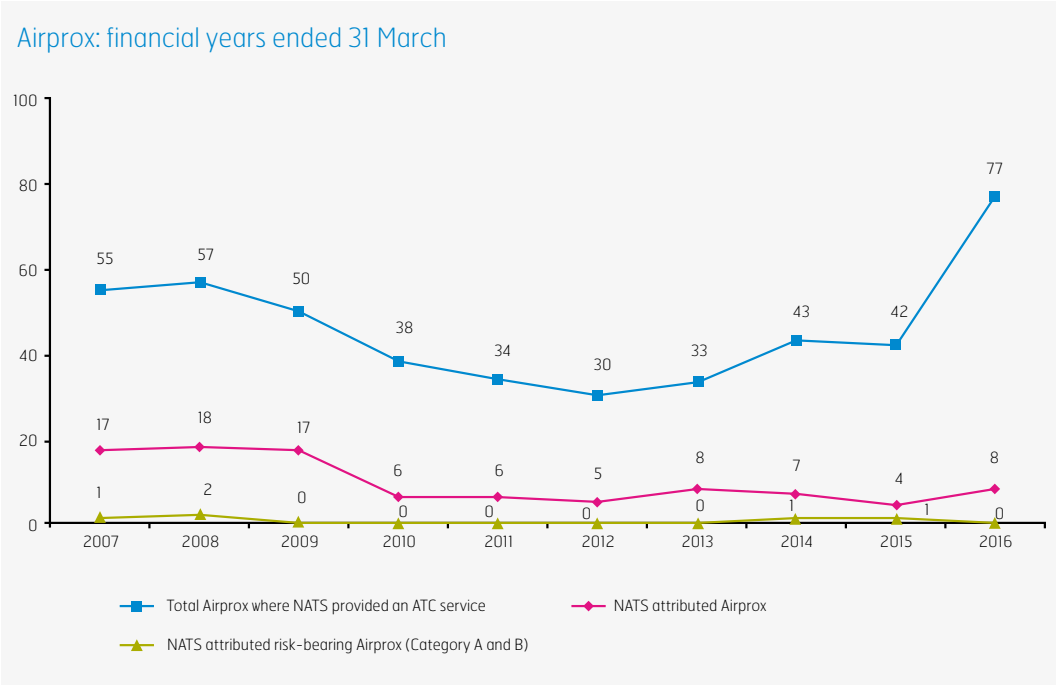
Safety performance

Our priority is the safety of aircraft and the travelling public. Our commitment to improving operational safety performance is embedded in our RP2 plan. This targeted a reduction in safety risk (defined as the accident risk per flight) of 13% by the end of RP2 for our en route ATC service, in line with predicted traffic growth. We have set the same target for our airports ATC service.

To monitor our performance against this target we measure the severity and risk of Air Traffic Management (ATM) incidents using the Risk Analysis Tool (RAT). On a 12-month rolling basis to the end of calendar year 2015 our performance generated a RAT score[8] of 1,497 relative to the target of below 1,209. While this performance is not meeting the challenging target we set ourselves, overall we performed better than calendar year 2013 but not quite as well as 2014, which was a particularly good year. In response to the RAT score we conducted a detailed review of our performance and implemented further safety improvements over the winter, particularly at airports, which is starting to show a positive impact.

This financial year there were no category A or B Airprox[5] events attributable to NATS (2015: one). The overall number of Airprox events was 77 (2015: 42), with eight attributable to NATS. The increase in Airprox overall was mainly driven by events involving Remotely Piloted Aircraft Systems (RPAS or drones).

From January 2015, the SES performance scheme set three targets to be met by the end of RP2, based on: the effectiveness of safety management, the severity of safety events and the extent of Just Culture[12] training. We are on track to meet all three targets by 2017, well before the end of the reference period.



Safety statistics for 2016 include NATS' assessment of the outcome of UK Airprox Board reviews

Safety, regulatory and economic environment

Safety
(continued)

Managing safety & change

Our approach to safety is underpinned by a commitment to continually improve our operational safety performance and minimise our contribution to the risk of an aircraft accident. We do this through a formalised, explicit and proactive approach to safety management.

We prepare Safety Cases that analyse and assess the impact of changes in people, technology, operational software and airspace structures to provide assurance that such changes are safe to implement. For the same reason, we also conduct hazard analysis on any changes to ATC procedures. Additionally, we seek to optimise operational staff performance through annual training, competency assessments and the development of new systems.

Over the next five years we expect significant changes to our operational environment as we deploy SESAR technology so this year we assessed the safety improvements that this programme will deliver, and identified the safety case activities required.

Safety improvements

The most significant operational risks we deal with are infringements of controlled airspace, level busts[13], issues on the ground at airports, including runway-related events, and human performance.

The number of risk-bearing level bust events reduced by almost 30% during the 2015 calendar year, with the total number of events reducing by 8%. We have continued to work with the CAA and airlines to ensure best practice is followed by both pilots and controllers.

We continue to focus on infringements of controlled airspace by engaging with airfields and flying clubs, as well as the CAA and airport operators. Although the number of infringements reduced slightly to around 630 in calendar year 2015, the number of risk-bearing events has increased by 10% over the same period.

The UK's Airspace Infringement Working Group (AIWG) in conjunction with the Airport Operators Association (AOA) and NATS has focused its prevention activity on the areas of highest risk. Disappointingly, this has not led to a reduction in infringements. In conjunction with the CAA and the leading general aviation organisations we are exploring measures to improve this situation and we expect the actions described in the Chief Executive's review to take place in 2016/17.

At airports, we responded to an increase in runway events in the first half of the year with more rigorous training, including further continuous professional development, and this has improved performance. We are also continuing to trial runway incursion sensors at Manchester and Aberdeen to assist in the development of automated runway incursion warning systems. While other ground events at airports do not contribute to the RAT assessment risk these generate additional workload and complexity in the ATC operation and are therefore a focus for NATS. For example, we have been engaging with the CAA and airport operators on strategies to reduce pushback and taxi errors.

Effective human performance is a critical element of ATM safety and we have introduced a programme to enhance this which covers: a 'back to basics' focus on core skills required for avoidance action and defensive controlling; operational preparedness and familiarisation; and refresher training on airspace, operating procedures and equipment as we introduce new SESAR technology.

Safety, regulatory and economic environment

Single European Sky (SES)

The Single European Sky (SES) is a European initiative to improve the way Europe's airspace is managed. Its purpose is to modernise Europe's airspace structures, air traffic management technologies and associated operational procedures so as to ensure forecast growth in air traffic can be met, safely and sustainably, whilst reducing costs and improving environmental performance.

Deploying Single European Sky ATM Research (SESAR) technology

The European Commission's (EC) SESAR programme is now in the deployment phase whereby the concepts and technologies developed and validated through the SESAR Joint Undertaking, a collaboration of airport operators, ANSPs and aviation industry suppliers, are introduced into operation across Europe. The EC appointed the SESAR Deployment Alliance to the role of SESAR Deployment Manager (SDM) in December 2014 to coordinate this deployment. The SDM is an alliance of the largest European ANSPs (including NATS), four airlines and 25 airports.

NATS aims to be at the forefront of efforts to improve the management of Europe's airspace to secure benefits for customers as early as practicable. For the reasons given in the Chief Executive's review above, deploying SESAR is a significant part of our capital investment plan for RP2 and the early part of RP3, and we have already achieved a number of important milestones. The EC is aiming for the initial SESAR projects to be deployed by 2025.

SESAR is already delivering direct benefits to our customers through the Time-Based Separation (TBS) and Extended Arrival Manager tools. For TBS, NATS' involvement in a SESAR airports work package helped us to build on that SESAR initial research, in partnership with Lockheed Martin. The deployment of TBS at Heathrow is expected to save 80,000 minutes of delay per year at the world's busiest dual-runway airport.

The Extended Arrival Manager project led directly to operational trials of Heathrow XMAN (cross-border arrivals management), whereby neighbouring ANSPs slow down Heathrow arrivals when runway capacity delays of seven minutes or more are predicted. This delivers significant fuel, cost and environmental savings to customers.

European funding is available through the Innovation & Networks Executive Agency (INEA) to support the deployment of SESAR technology. INEA provided £11m in the year towards our investments. Access to this support ultimately reduces the costs we need to recover from our airline customers.

UK aviation strategy

The UK's Future Airspace Strategy (FAS) is designed to modernise airspace and the air transport route network to meet SES objectives. It includes the airspace managed jointly by the UK and Ireland Functional Airspace Block (FAB). It is part of the Government's transport policy and involves NATS, airlines, airports and other aviation stakeholders. The most significant modernisation of airspace will be in the South East of England where London's five big airports and many smaller aerodromes create some of the world's busiest and most complex skies and in the growth areas in the North of England around Manchester, Liverpool and Leeds.

We delivered the first phase of modernisation this year, including changes to arrival and departure routes for London City and Stansted with new higher level routes over the sea replacing some previously over land and new routes enabling aircraft to climb to higher altitudes more quickly. Both of these changes reduce overflight noise for local communities.

However, our plans for RP2 anticipated a more significant programme of airspace modernisation to enable us to deliver more fuel efficient flight profiles for customers. It is now apparent that the industry is facing some significant challenges in delivering this airspace modernisation in the face of changing government and CAA policy, public opposition to changing aircraft noise patterns, particularly in the London TMA[14], and in the light of a still pending decision on runway capacity in the South East.

Progressing with the original airspace modernisation plan in these circumstances would not generate the benefits required and our customers are understandably disappointed. Therefore, we have consulted our customers on a revised plan which will now focus on other smaller airspace changes to upper airspace levels which could be introduced in RP2 earlier than the original programme. This should go a long way to achieving cumulative fuel savings in RP2 similar to the levels originally planned. We will then develop proposals for modernising lower airspace levels in RP3, subject to revised government policy on airspace modernisation and clarity on runway capacity.

Safety, regulatory and economic environment

Single European Sky (SES)
(continued)

We are actively engaged with the Department for Transport, the CAA and the aviation industry to determine the most appropriate response to the airspace challenges the industry faces.

Economic regulation

In the UK, the principal regulatory developments in the year relate to airspace strategy and governance and ring-fencing, which are relevant to NERL, and to airport ATC (or Terminal Air Navigation Services - TANS), which is relevant to NATS Services. In Europe, the EC is in the early stages of preparation for RP3 by releasing a public consultation on its evaluation of RP1. It also issued a white paper on its objectives for RP3 in June 2016.

In light of the challenges facing the industry to deliver the UK's Future Airspace Strategy, the CAA has enhanced the requirements relating to NERL's annual service and investment plan consultation with customers, to include an independent review of progress against plans. The basis for a specific licence requirement for NERL to set out detailed plans to raise the UK Transition Altitude[15] to 18,000 feet by 2018 and implement the terminal airspace redesign associated with LAMP, is being reviewed by the CAA. These changes are not in NERL's direct control and are dependent on public consultation and other stakeholders.

In 2013 the CAA raised a concern that arrangements for governance and ring-fencing of NERL may need to be strengthened to ensure that users are adequately protected from risks which arise outside of the regulated business, and this year it completed its review. The company has agreed to make changes to NERL's Board arrangements and to enhance its reporting on the adequacy of its resources to deliver its licence obligations.

The UK market for TANS is subject to the market conditions test within EC SES Regulations. If conditions are not met TANS are subject to economic regulation. Last year the UK made its submission to the EC on the existence of SES market conditions for TANS. The Commission's decision on this is awaited.

Safety, regulatory and economic environment

Outlook for air traffic

	2016	2015	Year on year change
	('000s)	('000s)	%
Chargeable Service Units	**10,102**	9,815	2.9%
Total UK traffic (flights):			
Domestic	**377**	375	0.5%
North Atlantic	**333**	321	3.7%
Other	**1,568**	1,520	3.2%
Total	**2,278**	2,216	2.8%
Oceanic traffic (flights)			
Chargeable flights	**447**	418	6.9%

Overall, the volume of UK flights handled by NATS increased by 2.8%, reflecting an improving economic outlook. Domestic flights saw a small increase, with Flybe starting services from London City.

Chargeable Service Units[16] (CSUs) benefited less from growth in transatlantic flights as these took more southerly routes due to the jet stream, which led to shorter distances flown in UK airspace.

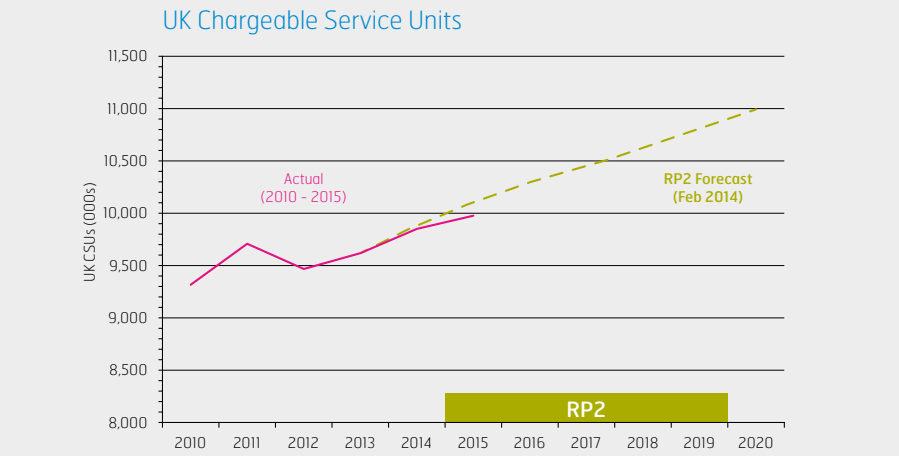
The RP2 settlement was based on a STATFOR[17] (February 2014) forecast that assumed flight volumes and CSUs would grow by 1.9% and 1.8% per annum on average respectively, with traffic levels returning to the pre-financial crisis peak (2007) shortly after the end of RP2. While flight volumes have grown by more than the RP2 forecast, the growth in CSUs has been less than the regulatory settlement assumed. For this reason, the company's revenue since the start of RP2 to 31 March 2016 has been £5m less than the settlement allowance.

The STATFOR (February 2016) forecast is for CSUs to be 0.4% higher than the RP2 forecast for the RP2 period.

Historically, the growth in demand for air travel has been closely linked to the strength of the global economy and, for UK air traffic, to that of the UK, US and Eurozone.

The UK economy grew by 2.3% in 2015 and is forecast to grow by 2.1% in 2016 (source: Oxford Economics), supported by lower oil prices and low inflation. The US economy continued to grow during 2015 based on strong domestic economic fundamentals and is expected to see growth of 2% during 2016. Eurozone economies also continue to build momentum with a weaker euro supporting stronger exports. Recent reductions in oil prices have reduced the cost of air travel and are contributing to passenger demand. The Middle East market continues to grow.

However there remain significant risks to this outlook. The potential impact of the UK's EU referendum decision on the UK economy and on the demand for air travel is uncertain. There are also risks to growth from a weaker outlook for emerging markets, with the slowdown in growth in China, and the recessions in Brazil and Russia likely to have an adverse impact on demand for air travel, although the IATA forecasts are still showing strong demand from passengers in these regions. Finally, there is also a risk from the potential escalation of conflicts in the Middle East.

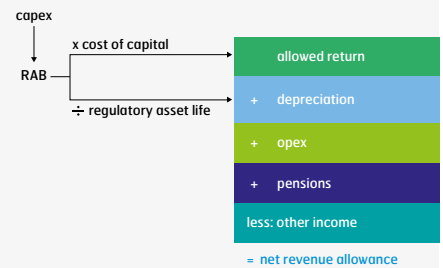


Our business model

We generate our income from the provision of ATC and related services. Our activities are mainly conducted through NERL and NATS Services.

NERL is the sole provider of air traffic control services for aircraft flying en route in UK airspace and the eastern part of the North Atlantic. It operates under a licence granted by the Secretary of State under the Transport Act 2000. The Act gives the CAA the role of economic regulator. En route, London Approach and North Sea helicopter advisory services are regulated by this licence. NERL also provides the MOD with engineering, surveillance and communications services.

The CAA establishes revenue allowances for NERL's economically regulated services under SES legislation. These remunerate NERL's efficient investment (capex), operating costs (opex), pensions and an allowed return on the capital invested in the Regulatory Asset Base (RAB) to recover the cost of capital. The RAB, which represents the value ascribed to the capital employed in the regulated businesses, is adjusted to reflect asset additions, disposal proceeds, regulatory depreciation and the rate of inflation. Income generated outside of NERL's economically regulated activities is deducted under a 'single till', leaving a net revenue allowance. A price per service unit is set to recover this based on forecast traffic for the reference period. This regulatory model is illustrated below.



The price control for RP2 was based on total revenues of £2.7bn (expressed by the CAA in 2012 prices) and provides for a real pre-tax cost of capital of 5.9%. The CAA also sets targets, and provides incentives, for service and environmental performance. If regulatory and other assumptions are borne out in practice, then NERL would earn a return of 5.9% p.a. It can earn additional returns if it outperforms the CAA's assumptions by being more cost efficient, by financing its business at lower cost, if traffic volumes (after risk sharing - see below) are higher than forecast or if it outperforms service targets. NERL would earn lower returns if the opposite applied.

The EC legislation provides: a risk-sharing mechanism to protect against certain variations in traffic volumes from the level assumed; an adjustment to charges for differences between actual inflation and assumed inflation; and an adjustment to charges in subsequent reference periods where cash contributions to the defined benefit pension scheme differ from those assumed due to unforeseen financial market conditions. The CAA also sets a target and cap on the level of NERL's gearing at 60% and 65% of net debt to RAB, respectively. Charges may be adjusted on a year 'n+2 basis' for service performance incentives, traffic volume risk-sharing and for inflation.

NATS Services is organised between UK and international activities. The former represents about c. 95% of its revenue. It provides airports ATC, engineering, information, consultancy and training services to its customers which include UK airport operators, the MOD, airlines, wind farms and other airspace users.

Airports ATC and related engineering services are provided to 14 of the UK's civil airports, and Gibraltar and three airfields under the UK military's Project Marshall contract (Wattisham, Netheravon and Middle Wallop). The UK has 128 civil licensed aerodromes and of these 110 self-provide the service. Of the rest, 14 are outsourced to NATS Services and four to two other providers. NATS Services operates in a contestable market and faces competition from other Air Navigation Service Providers (ANSPs). As noted above, large UK airports fall within the scope of European SES regulations. FerroNATS, our 50:50 joint venture, provides a service to 9 airports in Spain.

Our engineering services deliver complex turnkey engineering projects. Our competence is in maintaining and developing communications, navigation and surveillance solutions. We provide services to airports, the MOD, wind farms and construction companies, mainly integrating new infrastructure at airports. Our principal competitors include systems integrators, equipment manufacturers and specialist engineering consultancies.

Our business model
(continued)

Our expertise in information services derives from managing aeronautical and air navigation services data, charting and other services. These services are provided to commercial airlines, wind farms and other airspace users.

Our consultancy expertise has evolved from our operational ATC experience and enables us to optimise the safety and operational performance of airports or ANSPs by providing practical advice on maximising the capacity of airport and airspace infrastructure. The consultancy market includes other environmental, engineering and infrastructure consultancy firms. NATS also provides training services which are in competition with those also offered by other ANSPs and specialist colleges.

We are uniquely placed to help airline and airport customers to realise value by making both airspace and airfield services more efficient. We understand the complex interactions at each stage of a flight between airlines, airport operators and ANSPs, including in some of the busiest airspace in the world. We understand the benefit we can provide from fuel efficient flight profiles, approaches and departures, minimising delay, and through arrival and departure management. Our en route operation provides a seamless transition between the North Atlantic and UK en route services. We recognise that airport tower services are an intrinsic part of overall performance and our experiences at Heathrow, Gatwick and other airports demonstrate our ability to optimise runway performance and apron efficiency. This benefits airport operators, their investors, and the airlines.

Principal risks and uncertainties

The operational complexities inherent in the business leave NATS exposed to a number of significant risks and uncertainties. Our risk management process has identified the key risks that the Board believes are likely to have the most significant impact on our business, financial position, results and reputation based on the severity and likelihood of risk exposure. Risks are reviewed and re-assessed regularly and reflect the Board's assessment as at the date of this report. The list is not intended to be exhaustive.

The group has maintained a focus on mitigating these risks, although many remain outside of our control – for example changes in regulation, security threats, environmental factors and the impact of longevity and financial markets on pension funding.

A summary of internal control and risk management processes is on pages 57 and 58.

Safety: the risk of an aircraft accident

A loss of separation attributable to NATS that results in an accident in the air or on the ground would significantly impact NATS and its reputation as a provider of safe air traffic services. This could result in loss of revenue in the short term as investigations take place and the loss of future contracts due to reputational damage. If notice was given by the Secretary of State requiring NERL to take action as a result of the accident and NERL was unable or failed to comply with the notice then ultimately this could result in revocation of NERL's air traffic services licence.

As a provider of a safety critical service, safety is the company's highest priority. To further embed our existing safety culture across the organisation and to mitigate safety risk, NATS operates and continues to refine and develop its strategic plan for safety and maintains a safety risk management system. The latter includes investigations and reviews of operational safety performance and individual incidents to identify and respond to contributors of safety risk.

Maintaining continuous operations

a. Loss of service from ATC centre

A loss of service would result in a loss of revenue as flow management procedures would be introduced to maintain safe separation. The extent of loss would depend on the time necessary to resume a safe service and the resultant level of air traffic delay. To this end NATS has contingency arrangements which enable the recovery of its service capacity. These arrangements were reviewed in light of the recommendations of the Independent Enquiry into the December 2014 technical failure.

b. Operational systems resilience

Operational service provision is increasingly dependent on the performance and resilience of engineering systems and communications, surveillance and flight data infrastructure. A number of mechanisms exist to identify systems resilience risks. These include regular reviews of system health through a series of structured questions with evidence-based outcomes. In addition, tactical issues are assessed following engineering updates to NATS' Safety Tracking and Reporting System to determine whether immediate escalation is required and to identify any emerging trends requiring investigation. Further mitigations have been considered following the recommendations of the Independent Enquiry.

Political environment and economic regulation

Policy decisions by the regulator, the UK government and the European Commission directly affect our businesses. Changes in policy decisions may impact on the group's ability to meet the requirements of the UK and EC's aviation policies. We seek to mitigate this risk by providing independent input to policy studies (such as that conducted by the Airports Commission) and lobbying for policy guidance where we believe this is required (such as airspace strategy).

Also, the group's air traffic services operate under a European regulatory regime which requires key performance areas to be met. Failure to meet these safety, service and efficiency targets could damage our reputation and lead to even more challenging regulatory arrangements.

The company's regulatory objectives include airspace design changes which are dependent on a stable and clearly defined aviation policy for the UK and agreement following public consultation and support from airport operators. The company is seeking to mitigate regulatory risk by aiming to achieve its RP2 targets through equivalent environmental and fuel saving benefits via a package of other airspace changes.

Principal risks and uncertainties
(continued)

Finally, the UK market for Terminal Air Navigation Services (TANS) is subject to the market conditions test within EC SES Regulations - if conditions are not met TANS are subject to economic regulation. Last year the UK made its submission to the EC on the existence of SES market conditions for TANS. The Commission's decision on this is awaited.

Defined benefit pension scheme

Adverse movements in pension asset and liability values arising from factors such as lower investment returns, lower real interest rates and improving life expectancy may increase the size of the pension deficit and result in significant contributions to fund pension benefits. Management regularly reviews the financial position of the defined benefit scheme and is consulted by Trustees on the design of the risk reduction strategies that are in place. The scheme was closed to new entrants in 2009, pensionable pay rises are capped and future service benefits are linked to the Consumer Prices Index. The Trustees are undertaking a formal triennial valuation of the funding of the defined benefit scheme as at 31 December 2015. The company expects this to report an increase in the funding deficit and for additional contributions to be necessary. The company has adequate financing arrangements and cash reserves in place to cover expected increases in contributions during the remainder of RP2.

Industry outlook and the impact of the UK's referendum on Europe

Poor market and economic conditions can reduce NERL's revenues to levels below those assumed by the economic regulator in making the RP2 price determinations. This in turn could impair shareholder returns. NATS monitors the key industry indicators on a monthly basis against RP2 forecasts and has taken action in the past to realign its cost base with lower revenues. As explained above, NERL has traffic volume risk-sharing arrangements that mitigate revenue reductions to a large extent.

If the UK votes to remain in a reformed EU, we do not anticipate a significant impact on NATS activities or business risks from the changes agreed with EU partners.

If the UK votes to leave the EU, in the longer-term, the impact of this decision depends to a large extent on the type of relationship that is forged between the UK and the EU. However, we do not expect that it will have a significant impact on NATS activities provided the UK continues to participate in the Single European Sky project (SES): our plans assume we deliver the SESAR technology in order to benefit our customers. It is also possible that progress with airspace policy may be slower than we hoped for in RP2 as the Government turns its attention to developing the new relationship with Europe and more globally.

However, in the shorter-term the initial uncertainty and market volatility that could result (e.g. exchange rates) could affect the demand for air travel and therefore our future revenue although any changes would be mitigated by traffic volume risk-sharing arrangements.

Security: electronic and other external and internal threats

Malicious attack, sabotage or other intentional acts, including breaches of our cyber-security, could damage our assets or otherwise significantly impact on our service performance. NATS seeks to mitigate these risks through its business continuity controls, staff awareness training and cyber and physical security processes and procedures, including monitoring political stability and security risks in countries where it conducts its business. The company has enhanced the physical security of its principal sites and is continuing to enhance its cyber-security processes and controls. The company maintains a close liaison with the majority of Home Office Constabularies as well as Government security agencies and departments including security advice from the Centre for the Protection of National Infrastructure.

Principal risks and uncertainties
(continued)

Employee relations

The deployment of SESAR technology and the group's response to the challenging competitive environment in the UK and overseas will require changes across our organisation. Industrial action could result in reduced air traffic service provision which adversely impacts on service performance. Every effort is made to maintain good employee relations at all times, including through our Working Together programme, to ensure the delivery of an efficient operational service and associated support. NATS has been negotiating with its recognised trades unions on a one year pay offer for 2016. Results of the customary ballot on this will be known in July.

Technology

The deployment of new SESAR technology and retirement of legacy systems could affect the group's ability to maintain a continuous service during transition and require additional costs to sustain legacy systems and support deployment. NATS maintains programme and project governance and risk management processes which are overseen by the Executive and Board, including the Technical Review Committee.

Other matters:

a. Sale of HM Government shareholding

Following an announcement that the HM Government shareholder is exploring the sale of its shareholding in NATS, the company is undertaking a review of the potential business impacts arising from this. This includes the impacts on key stakeholders and implications for financing arrangements, capital structure and credit ratings.

b. Financial risks

In addition to the top risks set out above, the main financial risks of the group relate to the availability of funds to meet business needs (including meeting obligations to the pension scheme), the risk of default by counterparties to financial transactions, and fluctuations in interest and foreign exchange rates. A detailed description of each of these risks and specific mitigations are set out in note 19.

Service line performance

We organise our activities according to service lines, which reflect the products and services that we offer. A brief description is provided under the section entitled 'Our business model'. This section explains the financial and operational performance of each service. The principal financial measures are revenue and contribution. The former includes intra-group revenue, while the latter reflects the operating costs which managers are able to influence directly. A reconciliation of service line contribution to operating profit is provided in the notes to the financial statements.

NATS Airspace

	2016	2015
Financial performance:		
Revenue (£m)	**715.3**	738.5
Service line contribution (£m)	**323.1**	380.2
Capital expenditure (£m)	**144.6**	152.3
Operational performance:		
Flights handled ('000s)	**2,278**	2,216
Risk-bearing Airprox (no.)	**nil**	1
Average delay per flight (seconds)	**4.3**	2.2
Enabled fuel savings (tonnes)	**11,000**	189,000

Service performance: calendar years	**2015**		2014	
	Target	**Actual**	Target	Actual
C1: avg. en route delay at FAB level (secs)	**15.0**	**4.8**	-	-
C2: avg. delay per flight (secs)	**10.2**	**2.4**	8.3	2.2
C3: delay impact (score)	**22.3**	**5.2**	23.4	4.2
C4: delay variability (score)	**2,000.0**	**14.2**	1,400.3	195.2
C3Di: 3Di metric (score)	**29.7**	**30.1**	23.0	29.8

The C1 metric is a Functional Airspace Block (FAB) level target introduced for RP2.

NATS Airspace includes all of NERL's economically regulated activities. It generated revenue of £715.3m, a 3.1% reduction on the previous year. This mainly reflected a full year's impact of the RP2 price reductions which applied to UK en route services from January 2015. This was partly offset by some improvement in revenue from North Atlantic en route activities, due mainly to better traffic volumes, and from the MOD and European organisations.

Service line contribution of £323.1m (2015: £380.2m) was 15.0% lower. In addition to the reduction in revenue, this mainly reflected higher pension costs, lower capitalised internal labour and an increase in contractor costs. The benefit of reductions in headcount offset other net staff cost increases.

The level of delay attributable to NATS Airspace for the financial year was 4.3 seconds per flight (2015: 2.2 seconds), with 99.6% of flights not delayed (2015: 99.8%). Some additional delay arose from the implementation of airspace changes in the last quarter of the financial year.

Service performance incentives are assessed on a calendar year basis and although performance for calendar year 2015 was broadly consistent with that of 2014, the tightening of service targets meant the incentive recognised in revenue of £4.6m was £1.1m lower.

In addition to measures of delay, we are targeted on flight efficiency (the environmental performance of our network). For the 2015 calendar year our performance at 30.1 was broadly in line with the target of 29.7[1]. Over the five years of RP2 the targets require a reduction in the 3Di score from 29.7 to 27.7. This progression assumes that planned airspace changes are achieved, a challenge the industry is facing and which is discussed above.

Service line performance
(continued)

Working with NAVCANADA we are trialling the first Reduced Lateral Separation (RLAT) track in the North Atlantic airspace we each manage. RLAT reduces the distance between aircraft, increasing the number of tracks available. This adds capacity, improves efficiency and environmental benefits by giving more capacity on optimum routings and levels within the airspace. Only suitably equipped aircraft will take part in the trial.

We deliver short term tactical benefits to customers from changes to procedures. This year we enabled fuel savings of 11,000 tonnes (2015: 189,000 tonnes) worth £3.5m to our customers (based on an average fuel price of £315 per tonne over the year).

The flight efficiency metric is discussed in more detail under 'People and responsible business'.

Our customers also set us targets under our Operational Partnership Agreement (OPA) to achieve short term operational improvements. This year, through its Flight Efficiency Partnership sub-group, the OPA set a target of enabling 10,000 tonnes of fuel savings per annum and a stretch of 15,000 tonnes. NATS exceeded the target by enabling 11,000 tonnes per annum. The OPA also set a stretch target to minimise the duration of short term Air Traffic Flow and Capacity Management regulations and this was achieved.

NATS Airspace invested £144.6m (2015: £152.3m) on its air traffic control infrastructure in the year. Of most significance was progress with SESAR projects, including the next generation of flight data processing systems (iTEC) which was deployed in limited service by the Prestwick Centre.

NATS Airports

	2016	2015
Financial performance:		
Revenue (£m)	**173.4**	190.1
Service line contribution (£m)	**40.0**	61.7
Capital expenditure (£m)	**1.0**	0.3
Operational performance:		
Airports served: UK (no.)	**15***	16
Airports served: Overseas, incl. JV (no.)	**10**	10
Risk-bearing Airprox (no.)	**nil**	nil

* served in the year. Gatwick transitioned out in March 2016 and transfers to NATS were: two military airfields (in April 2016) and Belfast City (in July 2016)

NATS Airports represents the performance of our UK airport contracts, military airfields and share of the FerroNATS joint venture. Revenue decreased by 8.8% to £173.4m (2015: £190.1m). This mainly reflected price reductions and the loss of contracts with Birmingham (from April 2015) and Gatwick (from March 2016). Revenue reduction and higher staff pension costs were the principal reasons for the lower service line contribution of £40.0m (2015: £61.7m).

Our strategic objective is to win and retain UK airport contracts. In this respect we achieved a number of important airport contract renewals including Aberdeen, Belfast International, Glasgow, Heathrow and Southampton. Sumburgh approach radar and East Shetland basin ATC and engineering services were also renewed. We were also awarded the ATC contract by George Best Belfast City Airport, where we have been providing engineering services since 2008.

Last summer we established a strategic partnership with Heathrow which has at its heart a set of working principles and specific incentivised targets in areas from delay performance and service resilience, through to aircraft noise reduction. Our joint objectives are to drive year on year performance through innovations in service and technology, to realise improvements for airlines and deliver a world class passenger experience for the travelling public. This year we helped Heathrow improve its safety, punctuality and resilience through the introduction of enhanced Instrument Landing System (eILS) on its two westerly runways to improve landing rates in low visibility and it was the first airport in the world to introduce Time-Based Separation, significantly improving performance on windy days.

We also transitioned air traffic control operations smoothly and seamlessly to the new provider at Gatwick and since 31 March have also taken on the operation of two MOD airfields under Project Marshall for the Aquila joint venture.

We continued to provide a safe service at airports with no risk-bearing airprox during the year.

Service line performance
(continued)

NATS Engineering

	2016	2015
Financial performance:		
Revenue (£m)	**32.0**	17.3
Service line contribution (£m)	**4.5**	4.3
Capital expenditure (£m)	**1.0**	0.2
Significant milestones:		
TBS Heathrow (Full Operational Service)		May
27R enhanced Instrument Landing System at Heathrow		August
27L enhanced Instrument Landing System at Heathrow		September
Electronic Flight Progress Strips at Newcastle		September
VHF Radio Communications System at RAF Shawbury		January
Frodsham (Mersey) Wind Farm Mitigation Radar		March

Revenue grew by £14.7m to £32.0m (2015: £17.3m) in the year due mainly to engineering support provided to the Aquila joint venture for its Project Marshall contract. Service line contribution of £4.5m (2015: £4.3m) was broadly in line with the prior year reflecting lower margin on the Aquila support.

We provide engineering services to a number of airports at which NATS Services does not provide the ATC service. This year we worked with Newcastle to install Electronic Flight Progress Strips into its ATC operation, improving efficiency and reducing controller and pilot workload, and fully integrating its operation into the en route network.

We continue to support wind farm operators and agreed turbine mitigation services for Tormywheel Wind Farm that will see a new radar system at Edinburgh airport and surveillance solutions for Frodsham Wind Farm at both Chester and Liverpool airports.

Service line performance
(continued)

Other NATS service lines

	2016	2015
Financial performance:		
Revenue (£m)	**22.4**	19.9
- Other UK business	**14.8**	15.7
- International	**7.6**	4.2
Service line contribution (£m)	**(0.9)**	5.2
- Other UK business	**0.8**	5.4
- International	**(1.7)**	(0.2)
Capital expenditure (£m)	**1.0**	0.7
Secured order value:		
UK contracts (£m)	**49.0**	40.5
Overseas contracts (£m)	**8.1**	5.8

Other UK business includes consultancy and information services and International mainly represents our operations in the Asia Pacific and Middle East.

The major part of other UK business revenue is derived from the production of aeronautical data, services to wind farm developers and to help improve airport performance. Revenue at £14.8m (2015: £15.7m) was lower than the prior year. These activities generated a service line contribution of £0.8m (2015: £5.4m) reflecting higher contract support and bid costs associated with the development of this business.

International revenues have grown to £7.6m (2015: £4.2m), with the Asia Pacific region performing better than expected. We are finding fewer opportunities in the Middle East at the moment. At a service line contribution level our international activities are reporting a loss of £1.7m (2015: £0.2m loss) as we continue to build our presence in these regions.

People and responsible business

People

If we are to achieve our operational and financial performance targets it is essential that our employees have a clear understanding of our business direction and strategy. For this reason, the Executive team visited every unit in a series of road shows to explain our priorities and to hear what staff have to say about NATS. As a direct result of those meetings, we will be revising our purpose and values over the summer to make these more engaging for staff.

Enhancing this personal and direct dialogue is key to helping all our people to understand better how NATS works as a business, the constraints under which NATS operates and the people flexibility that will be essential to our future success. New thinking about how we continue to deliver performance improvements will be required from every team member in order to continue to improve our performance and meet regulatory and customer expectations.

We are also thinking differently about how we deliver ATC and technical training to our customers and, in time, to our operational staff. This year we endorsed a Foundation Degree in Air Traffic Management at Kingston University which forms the first two years of a BSc in Aviation Studies. The course is only available to trainees of NATS customers and in the future may also be available to NATS trainees. NATS is teaching specific modules of the degree programme combining academic rigour with workplace learning. The programme will give students external recognition of their qualifications and an excellent grounding to become controllers of the future. The first students on the programme are from Avinor, the Norwegian ANSP.

NATS has been active in supporting young people interested in STEM subjects (Science, Technology, Engineering and Mathematics) through various schemes for some time, and this year we committed to support University Technical College (UTC) Portsmouth. The school will open in September 2017 and will offer 14-19 year old students the opportunity for a technical education alongside their general education. NATS will provide support to the engineering faculty through a variety of means, from direct contribution into the curriculum design to mentoring of students.

People and responsible business
(continued)

Responsible business

We are helping the aviation industry to build a more sustainable future by limiting and, where possible, reducing the impact of air traffic operations on the environment.

Our Chief Executive has responsibility for the group's environment policy, which is underpinned by an ISO 14001 certified Environmental Management System (EMS). The policy's governance is set and monitored by a Steering group, reporting in to the Executive team and is available on our website. Here, we report on the targets agreed with the regulator, commitments to our customers and the material environmental impacts of our operations. Our Responsible business report is available on our website.

Minimising the environmental impact of ATM

How NATS manages the UK's airspace directly affects airline customers, airports, their communities, the MOD and other users. We strive to balance the traffic requirements of our customers with the environmental impact of our operations, including aircraft noise for local communities. Modernising the airspace network, designed in the 1960s, is essential if we are to deliver meaningful service improvement. As explained elsewhere in this report, we can only deliver this with the support of all stakeholders.

Actions taken to minimise the environmental impact of our operations in the last year are set out to the right.

a. ATM-related CO_2 emissions

In 2006, we became the first ANSP to commit to reduce ATM-related CO_2 emissions, by an average of 10% per flight by 2020, for UK and North Atlantic airspace and airport tower services. To date, NATS has reduced emissions by an average of 4.3% per flight.

Working directly with our airline customers through the Flight Efficiency Partnership, NATS has delivered incremental adjustments to improve the efficiency of certain operational procedures. Together with tactical improvements, these helped save a further 34,000 tonnes of ATM-related CO_2 emissions in the year, with 1.1 million tonnes of CO_2 emissions cumulatively now being saved annually. This is equivalent to £111m in enabled airline fuel savings[18].

Energy & environmental performance (financial year unless stated otherwise)	**2016**	2015
Enabled ATM-related CO_2 emission reduction	**4.3%**	4.2%
3Di score (calendar year)	**30.1**	29.8
Energy consumption (MWh)	**60,404**	60,975
Scope 1 emissions (tonnes CO_2e)	**3,183^**	3,189
Scope 2 emissions (tonnes CO_2e)	**27,934^**	30,138
Intensity metric (tonnes CO_2e per £m of revenue)	**34.6^**	36.1
Water consumption (m^3)	**49,645^**	47,032

The data has been collected using the operational control approach and covers the UK sites of NATS Holdings Limited and its AQUILA joint venture, which is based at NATS head office. Data for 2015 has been restated following implementation of the GHG Protocol and additional internal verification procedures. Certain environmental performance metrics in the table above as at 31 March 2016 have been subject to external assurance by PricewaterhouseCoopers LLP (PwC). PwC have carried out a limited assurance engagement on selected 2016 metrics marked with an ^. A copy of the assurance opinion is available at http://www.nats.aero/environment/cr, as well as the basis of preparation for the selected energy and environmental performance metrics above.

People and responsible business

Responsible business
(continued)

b. Airspace efficiency

In 2012, NATS and the CAA agreed a methodology for measuring airspace efficiency, called 3Di. This helps us assess day-to-day progress towards ATM-related CO_2 emissions reduction. The 2015 calendar year average 3Di score was 30.1, just behind the target of 29.7 and within the service performance range set by the economic regulator. We continue to identify and target improvements in airspace efficiency.

c. Aircraft noise

NATS continues to work closely with industry partners in Sustainable Aviation (SA) on noise mitigation policy, as well as directly with individual airports and community representatives. We share our expertise in service of supporting agreed local noise mitigation.

Our performance on enabling continuous descent operations at airports, through our work with SA, made further progress this year and was re-accredited for the "Engaging Customers on Sustainability Award" as part of Business in the Community's Responsible Business Award.

We recognise the direct and indirect impact that aviation has on local communities and the need for us, as one of the key industry stakeholders to understand, and where possible, mitigate their concerns. Our aim is to help balance the needs of airlines, airports and the local communities, and find compromises that can work for all parties. Part of our aim is to help people understand the complexities of managing a geographically constrained airspace over a densely populated country in a world where more and more people want and expect to fly. It is our hope that this understanding provides a foundation on which we can make changes to the airspace that benefit as many citizens as possible in a fair and balanced way: both those that want to travel, and those that are affected by aircraft noise. Only through engagement of all parties: government, regulators, airlines, airports and communities, can this succeed.

Minimising the environmental impact of our estate

NATS is part of the government's Carbon Reduction Commitment Energy Efficiency Scheme and the Energy Savings Opportunity Scheme. Swanwick Air Traffic Control Centre is also part of the EU Energy Trading System.

We began the rollout of our EMS in 2013 and achieved ISO 14001 certification in 2014 for our head office and we plan to roll out the EMS across other sites over the next year.

The Strategic report was approved by the Board of directors on 20 June 2016 and signed on its behalf by:

Richard Churchill-Coleman
Secretary