Chief Executive's review

Covid-19

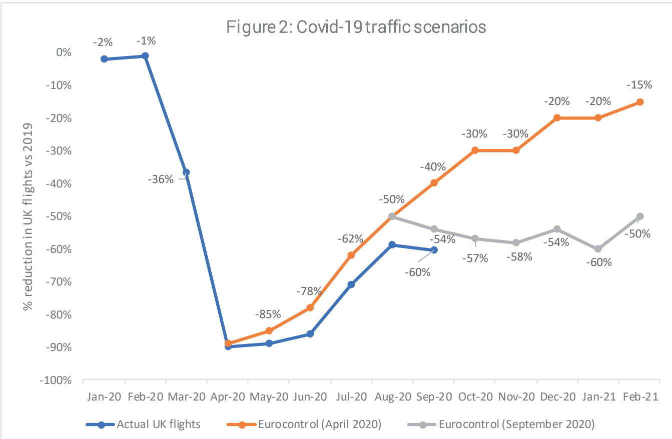
Covid-19 is presenting an unprecedented challenge to the aviation sector, in terms of its impact on the demand for air travel and the level of uncertainty of its recovery. As provider of the essential ATC service our role throughout this crisis has been to continue to provide customers and the public with the safe and resilient service they expect and to ensure that we are well placed to facilitate the recovery.

The UK's aviation sector was most affected from early March onwards as governments introduced measures to contain the virus and by the end of the month UK flight volumes fell to around 10% of the previous year and remained at this level through April and May 2020 (see Figure 2).

As it became apparent that the UK would be significantly affected by the virus, we took rapid action on three priorities: 1) protecting the health, safety and wellbeing of our workforce (see below) while maintaining a safe and resilient air traffic control service for our airline and airport customers; 2) preserving our liquidity in the face of a loss of income to ensure the viability of our business for all stakeholders; and 3) securing a revised regulatory settlement for RP3 which provides a balanced plan for dealing with a post Covid-19 operating environment.

In the Financial review we explain in more detail the liquidity challenge, our response, and the £380m of new funding which provides us with headroom to deal with a more prolonged period of recovery. One important consideration in conserving liquidity was our capital investment programme. From the commencement of lockdown in the UK, we reduced the number of contractors utilised, reprioritised work and redeployed our own employees. However, as the impact of Covid-19 on the industry became more apparent we suspended all capital investment for a six-month period, with the exception of critical sustainment activities. While our customers' focus is currently on managing the financial impact on their businesses, airspace modernisation (see Business review) remains a priority for them as it will make airspace more efficient and resilient and improve their environmental performance. It is important therefore, that we take some time now to reshape our capital programme for the future so that we can take advantage of lower traffic to make the airspace and technology changes that will deliver the benefits our customers need. Our hope is that we can still deliver some changes to our technology and airspace before significant traffic volumes return. Of course, we cannot predict the pace of recovery, and therefore we need to be agile as to when we resume the programmes to take advantage of the lower traffic.

Outlook for recovery in traffic



Projections for the aviation industry's recovery from Covid-19 vary widely but there is general agreement that its timing and extent depends on the containment of the health crisis, the loosening of travel restrictions and border closures and the restoration of passenger confidence to resume flying.

While it remains difficult to predict the rate of recovery in air traffic volumes, we do not anticipate a recovery to somewhere close to 2019 levels until 2023 at the earliest. There is no single industry view of the path to recovery and with Covid-19 still prevalent the outlook remains uncertain. Eurocontrol, Europe's network manager, has recently updated its near-term scenario (see Figure 2) which assumes a coordinated response between European governments and institutions. The most recent scenario suggests air traffic volumes will stabilise at around 60% below 2019 levels this winter. We developed our own internal scenario for planning our finances and managing liquidity which is somewhat more pessimistic.

In September 2020 UK flight volumes appeared to level off at around 60% below September 2019 levels, which was slightly better than our internal scenario. Airlines will soon publish their winter schedules which will be indicative of the level of passenger demand and the trajectory of the recovery in flight volumes in the short term. We anticipate that traffic volumes will remain flat through the winter period.

We are closely engaged with the Department for Transport and the CAA to support the safe, coordinated recovery of operations as traffic begins to increase.

Our workforce

I am immensely grateful to, and proud of, our people who have maintained the UK's essential ATC service during the pandemic. I cannot think of a better example of how our people embody the company's values. Our overriding priority from the start of the Covid-19 outbreak was the health and safety of the group's workforce. At the outset we took protective measures to ensure operational staff attending our centres and airports could operate under social distancing rules and to provide resilience to the service. We closed our training and simulations capability and stopped all but essential onsite maintenance. We also closed our corporate centre, initiating working from home for all non-operational staff enabled by the digital workspace we implemented earlier in the year. This has allowed us to continue to collaborate and communicate effectively during the crisis, including regular updates to staff on business developments from me and my executive team. It is clear that our digital workspace has enabled a more flexible way of working for much of the workforce and I intend to integrate the positive aspects of this fully into our future operating model.

I am also grateful to staff who were furloughed during this period of uncertainty as this enabled us to use the government's job retention scheme. At the peak over 3,000 staff were furloughed.

We have also conducted regular wellbeing surveys to enables us to gauge how best to support staff through this challenging period and we are now starting to develop plans for what a return to the office might look like, though we do not expect large numbers to return to our sites before early 2021.

It is never desirable to have to announce job reductions, but there is no escape from the fact that there are going to be fewer flights and therefore less company income for a number of years. Customers and the regulator will expect and require us to play our part to support the recovery through efficient pricing, consistent with a smaller business than the RP3 performance plan assumed. As a result, in August 2020 we announced a voluntary redundancy programme, and we will not be recruiting until at least next summer.

Notwithstanding Covid-19 and the challenging operating environment, our people strategy remains to attract, develop and retain the highly skilled and increasingly diverse workforce we need to meet the demands of our industry.

Economic regulation

Last autumn, the Board took the difficult decision to reject the CAA's decision for NERL's price control for Reference Period 3 (RP3: 2020 to 2024), which led to a reference to the Competition and Markets Authority (CMA) by the CAA. We did so because we could not conceive of a plan that would deliver the operational service, technology change and airspace modernisation that was needed by the aviation industry with the resources that the CAA was proposing, and for this reason we believed the plan was not in the public interest. Also, accepting the plan and then failing to deliver it would have significantly damaged our reputation and put us at risk of a breach of our licence. Until Covid-19, the CMA reference was a key priority for NERL's executive team and its Board. It is clear that our concerns and the evidence we presented was understood and acknowledged by the CMA in their conclusions. We did not persuade the CMA of our arguments in all the areas of dispute with the CAA. However, the CMA's decision sets important principles in key areas such as capital expenditure governance, cost of capital, the recovery of satellite data charges relating to the Oceanic service and the extent of NERL's ability to generate non-regulated income. The CMA's decision, while in many areas overtaken by Covid-19, continues to set us a stretching plan but addresses some of our concerns about the balance of funding for that plan.

The regulatory framework was never designed for an event as unprecedented as Covid-19 but provision exists for regulatory settlements to be re-set following major traffic shocks, and this is the case for RP3. The process for this review will not be known until CAA undertakes its consultation. However, we anticipate that this review will enable us to develop and consult on a new business plan with our stakeholders which will reflect their views and priorities for the remainder of the RP3 period. Our fundamental strategy remains to modernise our technology, in line with SESAR principles and to enable airspace transformation that will deliver significant benefits to customers. However, we recognise that this must be set within a very different economic climate. Despite the near-term uncertainty for the recovery of air traffic volumes and the regulatory framework for RP3, the long-term fundamentals of our business remain sound. Over the next twelve months we will engage our stakeholders to understand their priorities post-Covid-19. As the regulatory commitment to the traffic risk sharing mechanism indicates, there are limits to the extent that air traffic costs can respond to changes in traffic volumes. Nevertheless, we wish to use the room for manoeuvre that we have and have started to re-size our business to reflect a lower level of demand for our service over the next few years. In doing so we are considering the needs of all our stakeholders, including our airline customers, the travelling public and the workforce, ensuring that the decisions we make support the recovery in aviation and are in service of the long-term success of the company. We provide an essential public service and we are resolutely committed to delivering our strategy to advance aviation and keep the skies safe in the interests of all stakeholders.

Martin Rolfe, FRAeS

Chief Executive