Refinancing the Public Private Partnership for National Air Traffic Services

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John Bourn
Comptroller and Auditor General

National Audit Office
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The National Audit Office study team consisted of:

Neil Carey and Paul Oliffe under the direction of Patricia Leahy

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For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Summary

1 This report is a follow up to our July 2002 report on the Public Private Partnership for National Air Traffic Services Ltd, the UK's main air traffic control provider, (Appendix 1). We reported that the PPP contained many positive elements, but that the financial position of the Company needed strengthening to enable it to make further vital investment to expand the capacity of air traffic control. In particular, NATS' indebtedness to banks, and comparatively little equity from investors, made the organisation vulnerable to severe downturns in traffic, such as that which followed September 11th 2001.

2 Since September 11th there has been a major refinancing exercise involving NATS, its banks, the Department for Transport, the Airline Group, a new investor, BAA plc, and the Civil Aviation Authority. Reflecting contributions from each of these participants, the outcome has been described as "The Composite Solution".

3 The key question which we sought to address through our examination was whether, in light of the refinancing exercise, NATS now has robust finances, to which all the company's main stakeholders have made equitable contributions. Our approach is detailed in Appendix 2.

More robust finances

4 NATS' finances are more robust than before. The robustness of the new financial structure has been tested by modelling a wider range of exacting scenarios than those used when setting up the PPP. For the refinancing the extent and nature of scenario testing was agreed between all the parties, including NATS' management and the Company's economic regulators in the Civil Aviation Authority, as well as independent credit rating agencies. NATS regards the combination tests, which combined possible traffic shocks with adverse trends on costs, as particularly severe scenarios which provide strong assurance of robustness. Compared to before the Composite Solution, the PPP now has a much stronger buffer of cash reserves with which to cope with possible future crises.

5 The Composite Solution avoids highly uncertain alternatives for NATS that all stakeholders, including NATS' customers, considered could be worse. Possible alternative outcomes included:

- The Company going into administration, which could have put the value of both the Airline Group's and the Government's existing equity stake in NATS at severe risk and prejudiced the future development of the Air Traffic Control System. For the banks who had financed NATS, administration would have risked their loans, leaving the fate of these in the hands of an Administrator;
- The Company being returned to public sector ownership and management, thereby potentially leaving NATS' customers to shoulder the entire financial burden; or
- The banks curtailing NATS' capital and operating expenditure to the minimum required for the purposes of meeting statutory obligations and retaining the operating licence, or disposing of parts of the business. All other parties were concerned to prevent the Company being placed in such a situation from which it could not move forward.

All parties contributed to the Composite Solution in different ways and degrees

6 Assembling the Composite Solution required consistent progress to be made on five parallel fronts, each of which were major projects in their own right. The projects were:

- A cost reduction initiative within NATS;
- Implementation of the interim solution, a temporary working capital facility;
- Identification and selection of a new corporate shareholder;
- Extensive revisions to NATS' three major bank facilities for the Company's acquisition, working capital and capital investment; and
- Negotiations between NATS and the Civil Aviation Authority following NATS' request for the relaxation of the caps on its prices and other changes in the regulatory framework.

NATS is making cost reductions

7 As its own contribution to the Composite Solution, NATS plans to reduce costs by some £170 million (just over ten per cent of total costs) over the four years ending 2005/06. The main sources of these reductions are savings in support costs, a pensions contributions holiday and fewer air traffic controllers than was assumed in the Airline Group's original bid for NATS. NATS has also deferred capital expenditure (in part reflecting slower projections of growth in traffic) to conserve cash. NATS still expects its investment programme to cope with the possibility of higher than expected growth in traffic over the next ten years. Because NATS expects its high case demand forecasts to be revised down, the apparent risk of a shortfall of capacity until 2009 should not be as significant as it appears.

Government and a new investor put in new money

8 Following September 11th it quickly became clear that the Airline Group were unwilling or unable to invest more money in NATS. Given the difficult and uncertain conditions facing the Aviation Industry, the Group's inability or unwillingness to pay was taken as read and not subject to detailed examination. The Airline Group's preference was for a proposal where they retained their controlling majority on the NATS Board and supported the overall solution. The Department, backed by the Treasury, resisted proposals from other participants that the Government should provide the entire investment that was required, as this would have resulted in an effective end to the PPP and a loss of the benefits associated with it. Therefore a new investor was sought. The selection process that followed identified BAA plc, the largest operator of airports in the UK and a customer for NATS' services, as the most suitable investor. Steps were taken to identify and address any perceived conflicts of interest from having this customer as a shareholder. Many participants in the refinancing expressed their approval to us that BAA plc has become a shareholder in NATS. Its business has natural synergies with NATS'.

9 After internal savings and an expected relaxation of the price caps by the regulator, NATS submitted a formal business case for a total new investment of £130 million, £65 million each on equal terms from the Department and BAA plc, thus satisfying the Government's condition that it would commit new shareholder funds only on the basis that the funds were matched by private sector shareholder capital. The Department concluded, on advice from its advisers Credit Suisse First Boston, that this investment in NATS would be commercially justifiable.

10 The Department obtained equal terms to BAA plc. This was important because:

- Matching private sector investment, pound for pound, broadly reflected the existing split between public and private sector share capital;
- Most of the new investment is ranked earlier for interest and capital repayment than is the Airline Group's investment and in some circumstances, it is as well protected as Bank debt;
- Equal terms gives added assurance that the terms are robust and strictly commercial; and
- Demonstration of the investment being on commercial terms protects the deal against challenges on grounds of state aid.

NATS' bank facilities are revised

11 The four banks which had provided the £730 million acquisition facility when the Airline Group bought a controlling stake in NATS were reluctant to relax the structure of the original PPP, and also needed to be sure that the terms of any new finance package would not prevent them from later syndicating their loans to other financial institutions. They made some concessions, particularly in relation to the key ratios, but successfully resisted substantial reductions to their margins and fees. In order to retain access to these facilities NATS now has to meet less onerous financial covenants, which are more akin to those found in corporate transactions than the previous project finance structure.

NATS' charges to Airlines were revised

12 The Civil Aviation Authority has made two main contributions to giving NATS more robust finances. Firstly, following consultation with the industry, it agreed that the Company's prices should fall less in real terms than the price cuts originally planned for the first five years of the PPP. Though these concessions will cost airlines some £100 million over the period 2003-2010, NATS' prices should still improve relative to prices elsewhere in Europe, where operators raised their charges by 12 per cent on average in 2002. Indeed, on the basis of the amounts actually paid by air users NATS has improved to become the fourth most expensive service provider in Europe. Secondly, the Authority has introduced an automatic risk sharing mechanism for the first control period for reducing the impact of future traffic fluctuations on NATS, by allowing it to raise its prices automatically to recover half of lost revenue attributable to traffic falls below the level forecast by the Company in November 2001, rising to 80 per cent of lost revenue in extreme circumstances.

13 Following the good credit ratings that NATS received from major ratings agencies, and armed with the £130 million of additional shareholders' funds, in August 2003 NATS successfully completed the refinancing of its debt. It replaced with the proceeds of a bond issue the remaining £600 million of debt that it took on when the Airline Group bought a controlling stake in the Company. The practical advantage of this refinancing is that bonds are a cheaper source of very long term finance, without more onerous conditions, and reduce the company's dependence on bank finance.

Transacting the deal was onerous

14 Getting to a deal took some 18 months, a period of disruptive uncertainty for NATS that was far longer than that endured by its peers in other countries, most of whom simply raised their prices to airlines. In some respects the costs and timescale were understandable given the number of players involved, many with divergent aims, and the time taken for a reasonable view to emerge on likely future traffic levels following the shock of September 11th.

15 Moreover, the Department's negotiations over NATS took place against a background of tense relationships with private sector financial institutions over lending to Railtrack, which had been put into administration in October 2001. Exercises of the scale and complexity of the NATS Composite Solution cannot be transacted without substantial cost. The costs disclosed to us appear to be broadly equivalent to one third of the costs incurred in transacting the original PPP; unsurprising given the sheer scale and duration of the exercise.

RECOMMENDATIONS

These recommendations build on those made in our earlier report on the NATS PPP. There are different points of view on the reasons for NATS' financial difficulties which necessitated the refinancing. NATS themselves and the Civil Aviation Authority tend to emphasise the importance of the heavy indebtedness of the original financial structure. The Department for Transport and their advisers put more emphasis on the severity of the downturn in traffic following September 11th, which they regard as unprecedented. We recognise both points of view, and that these issues are interrelated, but consider that there are important lessons for Departments to learn from this case on the financial structuring of PPPs.

Structuring Public Private Partnerships

1 Obtaining the Composite Solution was an immense challenge and success was not guaranteed. Largely due to vulnerability caused by high levels of indebtedness and the severe downturn in traffic following September 11th, NATS went through 18 months of disruptive uncertainty in order to deliver a solution which was robust and worked for all parties. Departments planning PPPs with their advisers should be aware of the implications of introducing complexities, tensions and interdependencies into corporate and financial structures, which could reduce value for money.

2 A business' own management team will generally be in a better position to understand the risks to the business than outsiders. The financial structure of a PPP should be shared and discussed with the company's management, and where relevant, the economic regulator, before it is finalised. Departments need to balance this against the conflict of interest which management have in pushing for a more conservative financial structure, and possible impacts on sale proceeds.

3 Testing of the robustness of a PPP should give particular consideration to the evaluation of those risks where the management cannot control the risks' occurrence and can only mitigate the effects.

4 Departments should ensure that PPPs are established with sufficient and freely accessible reserves, in the light of identified risks. It may not always be efficient to provide freely accessible reserves against risks that have been soundly evaluated as very unlikely, particularly if refinancing the business is likely to be a quick and straightforward alternative.

5 Where capital intensive businesses like NATS, that are particularly exposed to international shocks, are to have to their prices regulated, automatic mechanisms to share the risk of volume change with customers should be considered.

Conducting financial restructurings

6 Departments involved in restructurings which require concessions from shareholders and financial institutions should ensure that administration is presented as a realistic option, as was done in this case.

7 Before agreeing public sector financial support for PPPs in difficulty, Departments should allow sufficient time for the extent of the problem to be clarified. If urgent temporary support is required, they should use this to obtain undertakings of longer term support from parties who are not immediately contributing, as was done in this case.

8 Precisely matching new private sector investment, pound for pound and in detailed terms, as was done in this case, is a powerful strategy which can provide added assurance of Value For Money and which other Departments in similar situations should also consider.