The Public Private Partnership for National Air Traffic Services Ltd

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
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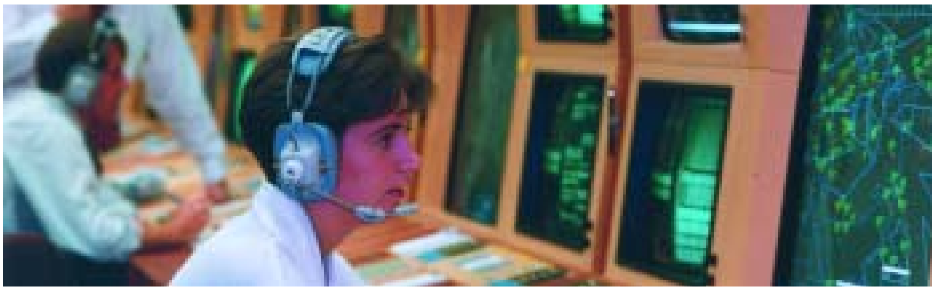
Summary

In this section

1 National Air Traffic Services Ltd (NATS) is the company which holds a monopoly of air traffic control for aircraft flying over the United Kingdom and, with its Irish counterpart, the North East Atlantic. It also provides air traffic control at most of the large airports around the country. The costs of its services are met by charges to users, mainly airlines. Until the Public Private Partnership (PPP) it was owned by the Civil Aviation Authority (CAA), which remains its regulator. Civil Aviation policy is the responsibility of the Department for Transport (the Department).



2 In 1997 NATS estimated that it required some £100 million of further capital investment every year for the next decade to increase air traffic control capacity to meet future traffic growth. But NATS could not be sure of getting this money: it competed with the rest of the public sector for finance and the Department had concerns over whether NATS could manage such a large investment programme efficiently. The Department and the Treasury concluded that the solution to this problem was to adopt a PPP for NATS which provided:

- above all, for standards of safety and national security to be at least maintained, in particular by separating service provision from safety regulation;
- an injection of private sector money and improved project management skills:
- for NATS to benefit from greater freedom to invest and to improve its services free of public sector constraints; and
- that in achieving these prime objectives the interests of the taxpayer should be safeguarded.

3 Accordingly in July 2001 the Government concluded a PPP with the Airline Group, a consortium of seven UK-based airlines, which was given operational control and a 46 per cent share of NATS, for nearly £800 million. This report examines the choice of the Airline Group and the extent to which the PPP promotes the achievement of the Government's objectives for NATS.

4 The selection of the Airline Group was based on the issues listed in paragraph 2 above, in particular the risks to standards of safety and national security, the raising of immediate sale proceeds for the taxpayer and the maintenance of effective accountability to Government. But the key challenge of the PPP is to provide a framework that enables NATS to secure the necessary investment for its business, while at the same time putting downward pressure on the prices paid by its customers. And there are risks to NATS' ability to secure the £700 million of external finance it needs to deliver the new capacity it considers necessary to meet traffic growth over the next ten years.

Selecting a strategic partner for NATS

5 The PPP was established following a highly competitive process. The Department sought to enhance competition by not barring companies in related businesses, but by allowing them to explain how they would deal with potential conflicts of interest. Seven bidders were able to respond to such a specialised requirement, but four of these dropped out before the later stages, one deterred by concerns over regulation of NATS' prices. The Department placed the third place bidder in reserve, but the remaining two bidders, Nimbus, led by the facilities management group Serco, and the Airline Group, competed strongly. Both had clear strategic reasons, based on NATS' fit with their existing businesses, to want control of the Company.

6 Overall there was little to choose between the Nimbus and Airline Group bids, though the Government's view, based on an objective valuation of both bids was that there was sufficient difference to make the Airline Group the right choice. Both met the required criteria for safety and national security. The Airline Group bid gave NATS a financial structure that the Department and their advisers considered acceptable, if not as robust as Nimbus' bid. Conversely, Nimbus accepted fewer of the Department's contractual terms than the Airline Group and sale proceeds would be slightly lower than for the Airline Group. Awarding the contract to the Airline Group also brought greater support for the PPP from other airlines, and from NATS' employees, who thought that their jobs and conditions would be more secure with the Airline Group. The popularity of the deal was not, however, among the evaluation criteria.

7 The Department signed a commercial agreement with the Airline Group in March 2001, subject to the fulfilment of conditions relating to financing and European Community merger approval. At this time the Airline Group bid was worth £95 million more in sale proceeds than Nimbus's. A major factor in this calculation was that the Airline Group had assumed a higher rate of growth in NATS' traffic and income than had Nimbus. This assumption had not changed in response to growing indications, from the end of 2000, that air traffic growth might be declining. In May 2001 the Airline Group told the Department that due to reductions in air traffic growth and to costs they had overlooked within NATS' they could not afford the price they had bid. The deal signed in July 2001 reduced initial proceeds to Government by some £87m to £758m, still £8m more than Nimbus. In addition, the Government was entitled to receive £35m in deferred proceeds at later dates. The Government's advisers estimated that these deferred proceeds would be worth around £21m in 2001 terms.

8 Costs to the bidders were in the region of £30 million. The Department's costs were £44 million, some £17 million more than they had estimated. This was mainly due to the PPP process being more complex and taking longer than the Department had expected, leading to higher fees to advisers. For example, the passage of the Transport Act took longer than expected, and the advisers to NATS and the Department did more work than planned to evaluate and manage risks to NATS' business, such as litigation with suppliers. The Department appointed their lead advisers, investment bankers Credit Suisse First Boston, (CSFB), on the basis of a fixed monthly retainer of £222,000 for 18 months, regardless of how much effort was required to fulfil the work specified in their brief. The Department accepted CSFB's position that it was not their practice to provide records to enable payment on the basis of actual time spent. The project timetable was extended and CSFB received the agreed monthly fee for some 33 months.

Achieving the objectives of the PPP

Safety and national security

9 The PPP provides for continuing high standards of safety, and for national security. A strong framework for managing risks to safety has continued in place, and has been supplemented with additional measures. NATS and the Ministry of Defence are continuing their joint civil and military management of airspace under the oversight and approval of the Civil Aviation Authority.

Accountability

10 Though the PPP cedes operational control to the private sector, it provides for public accountability. The three government-appointed Partnership Directors on NATS' Board have put in much more time than anticipated when appointed, because of cash flow problems affecting the company. The shareholders and the executive management consider that they have been effective as non-executive directors and have helped communications between the different parties at an important time. The legal agreements with the Airline Group and NATS' licence to operate air traffic control give the Government ultimate powers to intervene if there is a serious threat to the public interest.

Investment

11 Since the Airline Group assumed control, NATS has produced a business plan which proposes additional capacity over the next ten years to meet a high rate of traffic growth, and thereby limit flight delays. These proposals for expansion have withstood the scrutiny of airspace users within and outside the Airline Group, and of the Regulator. There are risks to the achievement of this plan, particularly in procurement of high technology systems, but NATS has strengthened its management team in important areas to help it deliver projects.

Finance

12 As a public body, NATS could pass all its costs to its customers. NATS is now in the private sector and has new freedoms, but is exposed for the first time to business risks arising from being unable to raise its prices in response to downturns in traffic. These affect NATS' ability to develop its business and finance its investment programme. Events following 11th September have highlighted these risks.

13 Any business, including NATS, can look to internally generated and external sources of finance. Internally generated finance is the surplus, if any, of revenues after meeting the costs of running the business, including paying interest on debt and any dividends to shareholders. External finance comprises borrowing from banks and other lenders and equity capital raised from existing or new shareholders. In the case of NATS there are particular constraints on all of these sources of funds.

NATS' sources and uses of funds

		Year to March 2002 £ million[1]	Year to March 2001 £ million
Turnover		**553**	595
Less costs:	**Wages and Salaries**	**(281)**	(260)
	Other net cash costs[2]	**(164)**	(224)
Net cash inflow from activities		**108**	111
Net interest on debt finance		**(36)**	*(31)*
Capital Expenditure		**(64)**	*(79)*
Corporate Taxation		**(6)**	*(2)*
Net cash inflow/(ouflow) before financing		**2**	*(1)*
Financing: Net new loans		**23**	-
Increase/decrease in cash		**25**	*(1)*

NOTES

1. Includes four months when NATS was in public ownership. September 11th occurred nearly half way through NATS' financial year.
2. Includes adjustment of all non-cash items.

Source: NATS - 2001/2 figures based on management accounts

Internally generated funds

14 NATS' revenues are the product of its air traffic volumes and prices, plus any non-air traffic income. In the short run NATS cannot increase its revenue: it has very limited control over volumes of traffic and its prices for en route services over the UK and oceanic services are regulated by the CAA. For technical reasons, moreover, NATS cannot normally raise its prices more frequently than once a year, even if the regulator agreed. NATS has adopted a cautious approach to the development of its non-regulated business due to the overriding need to conserve cash following the events of 11th September and to ensure that the core business is sustained.

15 NATS' major costs are largely fixed in the short term, comprising mainly staff wages, as well as repairs, maintenance and interest on capital in respect of its fixed assets.

Externally generated funds - Debt

16 NATS' initial financial structure saw NATS' debt rise from £330 million to £733 million to cover the sale proceeds paid to the Government. Despite warnings from both NATS itself and the CAA, that such a high level of debt would leave NATS vulnerable to adverse events, the Department concluded that the fears were misplaced. The Department's conclusion was based on modelling 19 adverse scenarios. The scenarios that were modelled all assumed consistent growth in air traffic, in our view an optimistic assumption compared with the experience of the past 30 years, which have seen three sudden and severe checks to growth in UK air traffic. CSFB emphasised to us that any reduction in the level of NATS' debt would have reduced sale proceeds, probably pound for pound.

17 NATS' ability to borrow has been constrained by the extent of its ability to service the debt. In addition to the provision of a £733 million facility to finance the acquisition of NATS, the Airline Group negotiated further bank facilities of £690 million to fund future capital expenditure, and a working capital facility of £30 million. The impact of the events of September 11th on NATS' revenue base were such that the company may have been construed as being in breach of certain of the provisions within its banking facilities. As a result, NATS agreed that it would not seek to make further drawings under the loan facilities over and above the £24 million already drawn and would fund capital expenditure from operating cash flow.

Externally generated funds - Equity

18 The only remaining source of finance for NATS is equity. In concluding that NATS' initial financial structure was adequate, despite the relatively high level of debt, CSFB considered that building up NATS' equity capital would be an inefficient way of protecting the company from the risk of financial stress, and that it would be better for the shareholders to respond to the company's needs if and when risks transpired.

19 But there are constraints on NATS' ability to look to its existing shareholders at times of stress. The Airline Group, as a consortium of airlines necessarily exposed to the risks of air traffic being lower than expected, is likely to be subject to financial stress at the same time as NATS. The other shareholder, the Government, is unlikely to be willing to put up extra equity capital without considerable investigation and debate.

20 That leaves new equity investors. It is a far from straightforward matter to find new equity investors for a business in financial difficulty, and once found, far from straightforward to negotiate the terms on which they will invest, as these will affect the interests of the existing shareholders as well as the company.

21 The constraints on NATS' ability to finance itself are illustrated by its response to the downturn in airline business since 11th September. NATS' en route revenue was around 14 per cent below forecast in the six months following the attacks. Costs are being cut but other expenditure has been postponed, for example a new control centre in Scotland, and redundancy packages for staff no longer required. Creditors are being paid more slowly.

22 In March 2002, the Government and NATS' lending banks made available a £60 million short term loan facility, to enable it to function effectively until September 2002. By this time NATS hopes to have obtained a new equity partner, putting its finances on a sounder footing. By careful management and rationing of its cash, NATS has not needed to draw on this facility to date. However there are continuing risks to NATS' finances. These risks are principally:

- **If NATS income does not recover.** There remains considerable uncertainty as to how quickly traffic, particularly more profitable North Atlantic flights, will recover. This is a normal business risk that cannot be removed.
- **If a new equity investor is not forthcoming, or if the Airline Group objects to a new shareholder.** Whilst declining to provide more equity, the Airline Group have undertaken to offer all reasonable co-operation in finding a new investor. The Department has said that it will act as a responsible shareholder and is willing in principle, to match an appropriate injection of new capital from the private sector.
- **If the Economic Regulator continues to be unconvinced by NATS' proposals for an increase in prices.** In May 2002 the Regulator, when replying to NATS' request made in February, stated that its final response will depend in part on users' views on a price increase and on financial strengthening of NATS. In practice strengthening will require more equity or an easing of debt repayment terms.
- **If the banks were to withdraw their support from NATS.** The Banks have an interest in avoiding the Company going into administration because this would place their existing loans at risk. They still retain rights to alter the structure, terms and pricing of their loans to NATS.
- **If the Government is obliged to apply for an administration order.** This is a last resort which the Government wishes to avoid. But it has said that it would take such action if necessary.

Recommendations based on the experience of the NATS PPP

To departments establishing joint venture companies or undertaking trade sales

1 A key aspect of joint venture companies or partial trade sales is that the state retains a long-term interest in the business. There are potential tensions between levels of proceeds on one hand and capital structure and financial risks borne by the business on the other. Departments should evaluate carefully bidders' financing propositions against a full range of reasonable business sensitivities, and consider an appropriate balance between proceeds and capital structure having regard to these sensitivities. Where appropriate, they should think about building in, up-front, mechanisms for addressing financial stress. We consider that in this case there was significant risk of stress because the financial structure made only limited provision for traffic downturns.

2 The financial structure of a joint venture company or part trade sale should be consistent with the business risks to which it is exposed. Although unlimited access to risk capital is unrealistic, Departments should look to build in mechanisms to enable the business to access further capital if it is required. In this case, the structure enabled the Airline Group to secure a loan facility, but the subsequent drop in forecast revenues has made it difficult to fulfil the loan conditions.

3 In judging the risk capital needed for a PPP, departments should have regard to such historical evidence as may be available on the business risks. In this case the risk capital reflected the experience of aviation growth in the 1990s, but not the interruptions experienced in earlier decades.

4 Vendor departments should give particular consideration to the detailed conditions that banks apply to their loans to Public Private Partnerships and the extent to which access to finance has been ensured. It is reasonable that banks should hold rights to protect their loans in extreme conditions but departments should carefully analyse the terms of any financing agreement to ensure that access to finance cannot unreasonably be withheld. In this case the finance agreements contain drawdown conditions requiring projections of ability to repay the loan. There is a risk that the banks will withhold lending that NATS requires for working capital or investment if the Company's cash flow forecasts, inevitably based to a degree on subjective assumptions as are all forecasts, do not remain healthy.

5 It is right that bidders should be able to take different views on future prospects. But where the level of proceeds is highly dependent on bidders' differing forecasts of trends that cannot be controlled, such as traffic volumes in NATS' case, departments should ensure that they are comfortable with the lead bidder's forecasts. If Departments are not comfortable with forecasts they should inform their evaluation of the bids by testing each bid's financial strength against common assumptions. In this case the Department accepted the Airline Group's forecasts.

6 Companies with the relevant skills and assets that would make them good strategic partners for a state business will often have possible conflicts of interest. It is good practice when considering expressions of interest from such potential bidders not to exclude them from bidding but to invite and evaluate their proposals for dealing with conflicts of interest, as was done in this case.

7 It is important to resolve key uncertainties, such as the level of regulated prices, as early as possible in the Strategic Partner selection process, to avoid unnecessarily deterring potential bidders. In this case the regulatory uncertainty had not been resolved when potential bidders were invited to submit proposals.

8 The most important adviser in a PPP is the lead financial adviser. Investment banks often prefer to work for fixed monthly fees, irrespective of how much work they actually do, but departments should give very careful thought to the risks of such an arrangement and the scope for better incentives such as linking fees to the achievement of milestones, before appointing an adviser on that basis. In this case the Department considered a success fee, but concluded that this was inappropriate.

To the Department for Transport

9 NATS' new strategy for procurement of air traffic control systems emphasises co-operation with air traffic service providers in other countries. There are advantages to this strategy, but it brings its own risks. NATS can learn from the lessons identified in the reports of the Committee of Public Accounts and this Office on international collaborations on high technology systems, particularly in the defence sector, (see Appendix 6).

An Overview of the Business of NATS, (See also Appendix 2)

USERS

NATS serves many different users of airspace

Scheduled Airlines

Recreational fliers

Freight carriers

Military flights

Charter airlines

Business aircraft

North Sea helicopters

INPUTS and RESOURCES

- UK and Oceanic airspace
- Air Traffic Controllers
- Accommodation
- Engineering Support Staff
- Administrative Support staff
- Radio Frequencies
- R&D staff and facilities
- Training staff and facilities
- Communication equipment
- Radar/sensing equipment
- Traffic processing systems (manual and computerised)
- Income from users, via charging powers and mechanisms
- Borrowing for investment
- Highly specified operating standards
- NATS' high reputation, knowledge and expertise

PROCESSES

- Recruitment and Training of controllers and engineering staff
- Maintenance and operation of existing manual & IT systems
- R&D, introduction of new ATC systems
- Application of detailed ATC procedures
- Charging users
- Consultation with users over use of airspace, procedures, investment and costs
- Capital investment
- Providing expertise to other countries

MAIN OUTPUTS

- No. of en route and approach flights controlled
- No. of Take-offs / landings managed
- Number of safety incidents (i.e. where aircraft are too close)
- Delay per flight
- Round-the-clock availability of ATC systems for NATS and MoD controllers
- Provision of sufficient controllers to handle variable demand for flights
- Detection of unauthorised incursions to airspace
- Volume of business won in other countries

KEY EXTERNAL INFLUENCES

There are many factors that impact on NATS' achievement of its objectives

- Other states' ATC performance
- Extent of traffic growth & congestion
- Performance of suppliers - IT
- Global or local economy
- UK policy for access to airspace
- Meteorological conditions
- Airlines' operational performance
- Runway capacity
- Economic/safety regulation
- Availability of supplier products and solutions
- UK and EU Legislation
- Risk of industrial action
- International obligations
- Military conflict

SHORT-TERM OBJECTIVES (<1 year)

- Reduce charges to users (RPI-3%)
- Reduce costs
- Opened Swanwick ATC centre on schedule.
- Agree 10 year Business Plan with Government, and obtain approval of the regulator
- At least maintain low level of safety incidents
- Renegotiate service contract with MoD.

INTERMEDIATE OBJECTIVES (1-5 years)

- Reduce costs
- Reduce charges to users
- Reduce delays
- Increase capacity through re-sectorisation etc of airspace.
- Reduce number of safety incidents
- Minimise aircraft fuel consumption
- Create working environment and conditions to incentivise managers and staff.

LONG TERM OBJECTIVES (>5 years)

- Reduce costs
- Reduce charges
- Reduce delays
- Increase capacity through increased automation
- Increase co-operation with other ANSPs
- Reduce number and rate of safety incidents
- Minimise aircraft fuel consumption
- Expand unregulated business
- Reduce number of en route centres to 2 with opening of New Scottish Centre.