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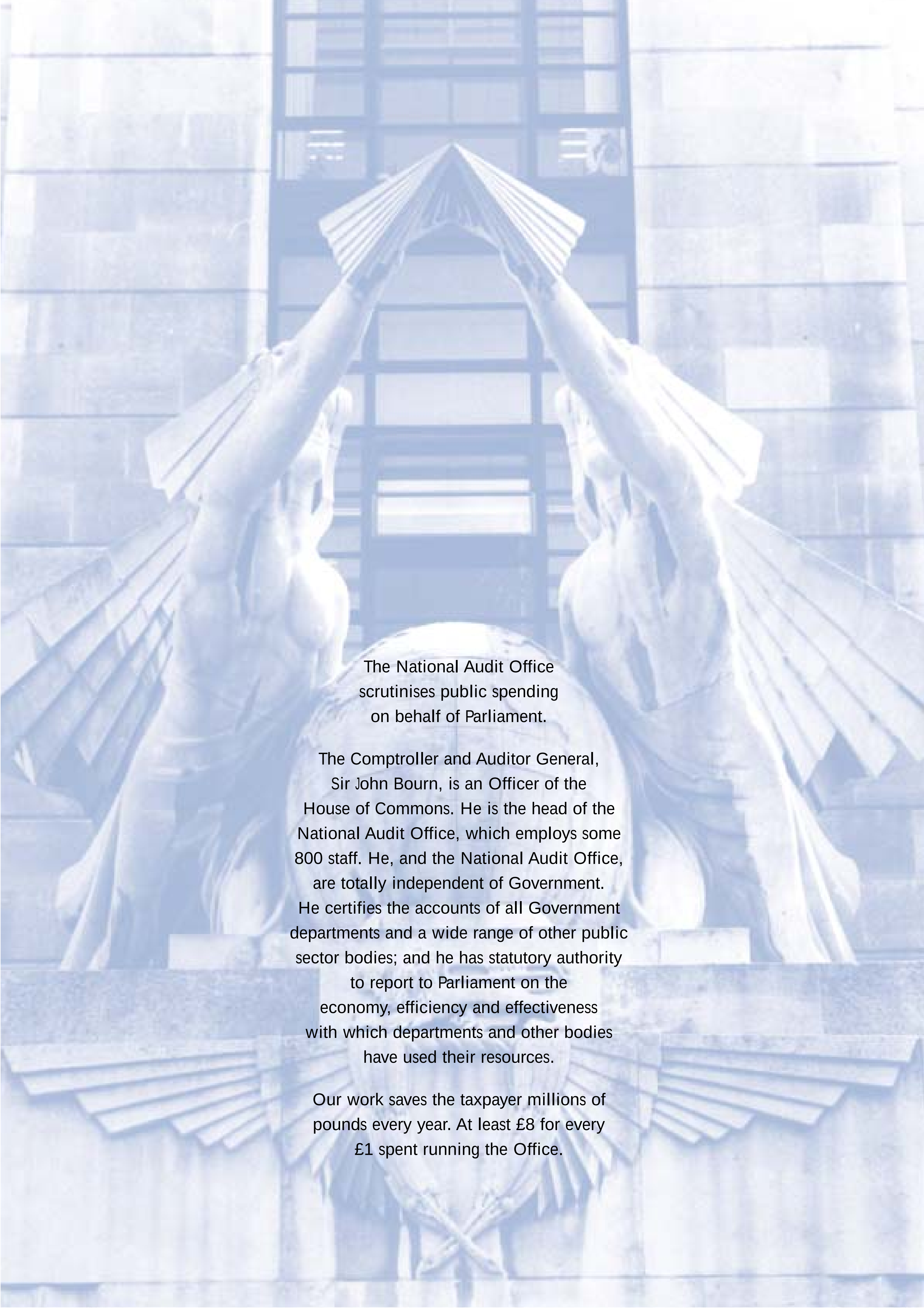
Refinancing the Public Private Partnership for National Air Traffic Services

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 157 Session 2003-2004: 7 January 2004



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John Bourn **National Audit Office**
Comptroller and Auditor General **22 December 2003**

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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

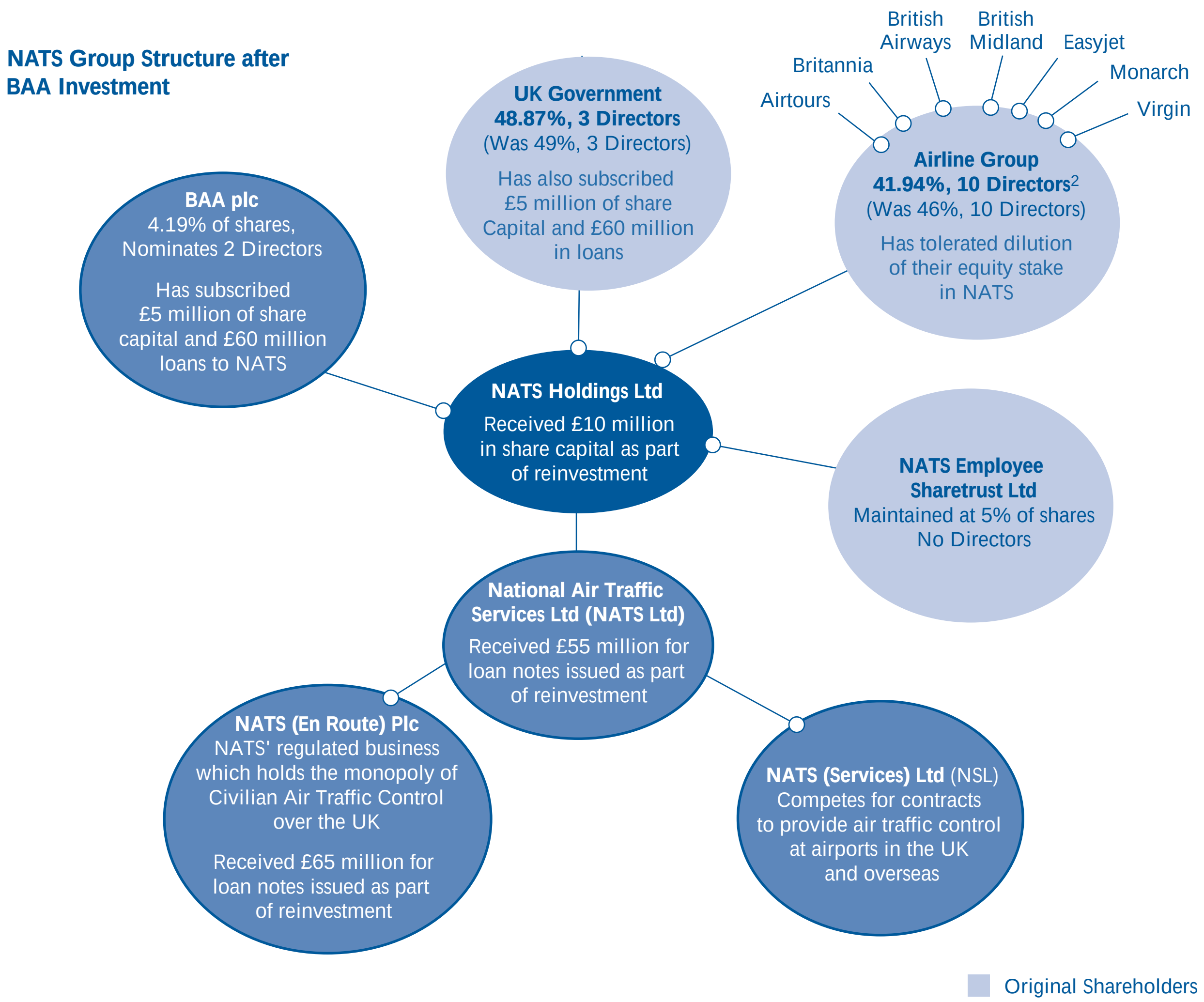
6 Departments involved in restructurings which require concessions from shareholders and financial institutions should ensure that administration is presented as a realistic option, as was done in this case.

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.

1 The changing structure of the PPP

The investment in NATS by BAA plc and the Government has resulted in changes to the structure of NATS Holdings Ltd



NOTE

1 The £130 million injected by BAA and the Department was applied to enable it as borrower to prepay part of the bank's loan facility. £10 million subscribed for NATS Holdings shares and £55 million subscribed for NATS Limited loan notes were invested in NATS' regulated business (added to £65 million subscribed for its loan notes) to enable it as borrower to prepay part of the bank's loan facility.

2 Airline Group had rights to appoint 4 more Directors. It can now appoint only 2 more Directors.

Source: National Audit Office

Part 1

More robust finances allow improved standards of service

1.1 This Report is a follow-up to our previous report on the Public Private Partnership for National Air Traffic Services Ltd, the UK's main air traffic control provider. We reported in July 2002 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. The taxpayer raised some £800 million from the sale of a 46 per cent stake in NATS to the Airline Group, a consortium of seven UK-based airlines. But the high proceeds were partly achieved by increasing the level of NATS' bank debt. NATS' finances, with increased 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. That severe down-turn had risked NATS' ability to fund and deliver its investment plan, which is essential to cope with the future growth in air traffic and prevent increasing delays to flights. A summary of the findings in our original report is in Appendix 1.

1.2 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". This part of the report examines whether, as a result of this exercise, the NATS PPP now has more robust finances to meet the challenges of the future. The approach used in our examination is described in Appendix 2.

NATS' finances are more robust than before

The financial structure has been more rigorously tested

1.3 During the negotiations that led to the original PPP, the Department for Transport and their advisers, Credit Suisse First Boston, as well as the Banks proposing to lend to NATS and the Airline Group, all tested the robustness of the financial structure for NATS proposed by the Airline Group. This took place in the context of a commercially confidential competition between the Airline Group and two other bidders. Other interested parties, such as NATS itself, and its economic regulator, the Civil Aviation Authority, were not involved in testing. In contrast, during the refinancing of NATS, both these important stakeholders were closely involved, supported by their own specialist advisers. In addition, the new investor in NATS, BAA plc, participated in testing the robustness of the new financial structure **(Figure 1)**, as did independent credit rating agencies. The extent and nature of scenario testing has been agreed between all the parties, and the results were shared. The robustness of the Composite Solution financial structure was tested against more than 80 downside scenarios.

1.4 In the aftermath of September 11th, which focused attention on NATS' exposure to severe downturns in aviation traffic, a wider range of adverse traffic scenarios was used to test the robustness of the new financial structure. **Figure 2** compares the extent of scenario testing, when designing the refinancing, with the testing that was performed under the original PPP. The banks also tested the robustness of the new financial structure.

1.5 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. They also told us that they took care to update their tests in the light of slower than expected recovery in the number of flights during 2002.

2 Testing the financial robustness of the PPP

Against the background of events following September 11th, the refinancing has been tested with a greater emphasis on traffic risks.

Key scenarios that were tested	Number of scenarios tested in the original PPP[1]	Number of scenarios tested in the Composite Solution[2]	
		Initially	Before Completion of the solution
NATS costs higher than expected	14	8[5]	0
Adverse Actions by the Company's Regulator	2	1	0
Alternative Financing	0	1	0
Adverse trends in NATS' Traffic and Revenue	**2**[3]	**5**[4,5]	**18**[5]
Various combinations of the above adverse scenarios	2	6	21
Totals	**20**	**21**	**39**

NOTES

1 These are described in greater detail in our previous report, The Public Private Partnership for NATS, Figure 21 page 38.

2 The final composite solution model contained 60 scenarios:

Initial scenarios were those requested by the Banks, BAA, and CAA. These scenarios were tested in order to satisfy the parties that the proposed structure was robust and viable and was a pre-requisite for signing the term sheet. These were subject to audit and shared between the parties.

Completion scenarios were run for (1) Rating Agencies - to ensure the structure would receive an investment grade rating to enable it to be refinanced in the capital markets and syndicated. An investment grade rating was also required by the CAA before they consented to the solution. Also (2) for NATS - to ensure appropriate internal due diligence and as part of good corporate governance; and (3) for NATS' Auditors - to ensure the structure was robust enough to meet Going Concern tests.

In addition to the 60 scenarios above, NATS and its advisors analysed more than 20 other scenarios throughout the Composite solution process to varying degrees.

3 One scenario based on continuing low growth at 3.5 per cent a year. One scenario based on the 1991 Gulf War, in which growth returned to the original trend line after one year of decline.

4 The five scenarios tested included; one of slow recovery from the post September 11th crisis, two based on longer and shorter Wars in Iraq, and two based on shocks to traffic in the second and third regulatory control periods, (2006-2010 and 2011-2015 respectively).

5 Scenarios include unfavourable regulatory outcomes.

Source: National Audit Office and NATS

The new structure should be more robust against adverse scenarios

1.6 There are several reasons why the new financial structure should be more robust.

Tests indicate that NATS is unlikely to default in a range of adverse circumstances

1.7 Our previous report demonstrated the critical importance to NATS of its inability to maintain healthy financial ratios in the aftermath of September 11th. Even before September 11th, both NATS itself and the Civil Aviation Authority had warned the Department that the capital structure of the PPP was, in their view, insufficiently robust. Though the Department for Transport had agreed to reductions in the indebtedness of the Company before completing the deal in July 2001, NATS and the Authority still remained concerned before September 11th. The Company estimated before September 11th that, in the event of significantly reduced traffic, it may not be able to generate enough cash to service its increased debts. After September 11th the Company initially estimated that it would run out of money by February 2002. However, this proved to be overly pessimistic.

1.8 **Figure 3** illustrates that the refinancing has restored the Company's finances to a level that should avoid the Company moving into a position of default even under severe scenarios.

3 Testing the robustness of NATS' finances

The refinancing has been fundamental to restoring NATS' ability to service its debts, even in adverse scenarios.

Illustrative Scenarios	Average traffic reduction[1]	Scenario Outcome in each control period CP1 2001-2005	CP2 2006-2010	CP3 2011-2015
NATS Base Case	0%	Ok	Ok	Ok
The Company does not default under any of these scenarios and therefore retains access to its banking facilities				
These scenarios are "worse case" in that they assume no management action or allowable use of loans or accounts to cure potential trigger events				
General traffic shock scenarios on the NATS Base Case				
1 Low Traffic AND a 3 per cent reduction continuing through 2006-2010	12.2%	Ok	Ok	Ok
2 A Traffic Shock equivalent to Sept 11 2001 in 2006-2010[2]	0%	Ok	Ok	Ok
3 A Traffic Shock equivalent to Sept 11 2001 in 2011-2015[2]	0%	Ok	Ok	Ok
Scenarios based on a 2 month War in Iraq in 2003				
4 Short Iraq War PLUS a 5 per cent reduction throughout 2006-2010	14.3%	Ok	Ok	Ok
5 Scenario 4 PLUS a further 15 per cent reduction in traffic	27.1%	Trigger	Trigger	Ok
6 Scenario 4 PLUS a further 10 per cent reduction in traffic AND Cost shocks[3]	22.8%	Trigger	Trigger	Ok
Scenarios based on a 6 month War in Iraq in 2003				
7 Long Iraq War PLUS a 5 per cent reduction throughout 2006-2010	16.3%	Ok	Ok	Ok
8 Scenario 7 PLUS a further 10 per cent reduction in traffic	24.7%	Trigger	Trigger	Ok
9 Scenario 7 PLUS a further 5 per cent reduction in traffic AND Cost shocks[3]	20.50%	Trigger	Trigger	Trigger

Scenario outcomes and notes

Ok No restrictions placed on Company other than those negotiated in the facilities agreement

Trigger Allows greater monitoring by lenders including a block on dividends, and the ability to review loan drawdown requests. Otherwise the Company is allowed to operate normally with full access to facilities.

NOTES

1 Traffic Reductions are expressed as annual percentage reductions against base case traffic forecasts for the first control period 2001-2005. Traffic is defined in terms of Chargeable Service Units, equivalent to a 50 tonne aircraft flying 100 kilometres.

2 Traffic reduces in the period following a Sept 11th profile with a peak annual reduction of 12 per cent in the second year.

3 Cost shocks consist of operating cost increases above base of £12 million in the year ending 31/3/04 and and £10 million in 31/3/05.

Source: NATS

NATS no longer bears the full risk of downturns in traffic

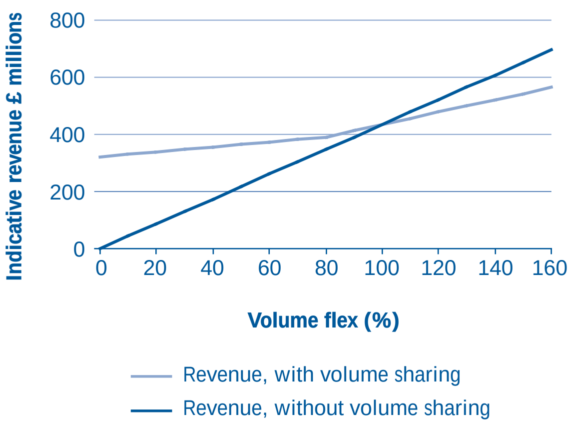
1.9 Under the original structure of the PPP, NATS was expected to bear the full effects of fluctuations in its income from changes in the amount of air traffic that it handled. In line with practice from other privatisations, its prices were determined by the Government for the first five years after sale, following advice from NATS' economic regulator, the Civil Aviation Authority. To increase its prices above the agreed cap the Company had to apply to the Authority for a modification to its operating licence, the outcome of which would take a minimum of several months to determine. This was a serious matter for the Company because though its costs, in the form of systems and staff, are largely fixed, its revenues can be volatile. NATS is particularly vulnerable to any decline in the level of transatlantic traffic, which accounts for 14 per cent of its flights but 43 per cent of its revenues, because North American flights traverse more UK airspace and use larger aircraft. At the time of the original PPP, there was no enthusiasm for the introduction of a mechanism for flexing NATS' charging rates dependent on traffic volumes.

1.10 As part of the new regulatory structure, the Civil Aviation Authority has, for the first price control period to December 2005, introduced flexibility to reduce the impact of traffic fluctuations on NATS. The Company and its airline customers now each face 50 per cent of both upside and downside volume risk. If traffic were to fall by a certain amount compared to a benchmark level, set at NATS' Base Case Forecast set in November 2001, prices will automatically rise so that, all else being equal, NATS would lose only 50 per cent of the change in revenue. NATS' base case estimate represents its view of how traffic should perform over the next three years, and so already takes into account effects of traffic falls following September 11th. In addition, if traffic falls even further, below a floor meant to represent a very severe crisis, NATS' share of the lost revenue would fall to only 20 per cent. This relationship is shown in graphical form in **Figure 4**.

1.11 Notwithstanding this fundamental change to the regulatory framework of the PPP, NATS still regards its remaining exposure to downturns in traffic as its most fundamental business risk.

4 Sharing the traffic risk

NATS is exposed to reduced risk from reductions in traffic under the new 'volume flex' arrangements. Its charges to airlines automatically increase as traffic decreases, making its total revenue less variable.



Source: CAA and NAO

There is now more clarity about the regulator's future intentions towards NATS

1.12 The new "volume term" is committed for only the first price control period, up to 2005. But the Civil Aviation Authority has recognised the need for NATS and its financiers and customers to have greater certainty about how the Company's charges will be regulated in the longer term. This is not a mere formality. For example, there had been a fundamental difference of view between NATS (and its banks) and the Regulator over whether the downturn following September 11th constituted an "exceptional circumstance", such as to allow NATS to seek an increase in prices under the existing terms of its licence. In March 2003 the CAA produced a statement of regulatory policy which clarifies its stance on a range of important issues, including support for financing new assets, and incentives for better performance and efficiency. The fact that NATS' licence continues unless and until notice of revocation is given and so is effectively for an indefinite period, has also been helpfully clarified by the CAA[1]. With more certainty about the stance of the Regulator, NATS has been able to raise finance from the private sector on better terms.

The regulator has better visibility over NATS future finances

1.13 In return for concessions to the Company, the Civil Aviation Authority has obtained, through revisions to the Company's operating licence, greater oversight of decisions which may carry a financial implication. It also now has stronger ring-fencing of the capital within the business to prevent leakage of funds from NATS' regulated business (the monopoly supplier of en route air traffic control over the UK). NATS is required to notify the CAA on the occurrence of certain events linked to its financial arrangements which might prejudice the financial robustness of NATS' regulated business. These events may include, for example, payment of dividends or commitments arising from NATS' other sources of finance.

NATS has refinanced its bank debt

1.14 Like most companies which borrow from the private sector, NATS has had the creditworthiness of its finances rated by the major Credit Ratings Agencies. Despite the much more unfavourable market sentiment towards the aviation industry following September 11th, Standard and Poor's Credit Market Services has assessed the underlying strength of the Company as "A-", which means a strong investment grade proposition. Moody's Investors Services rated NATS as "Baa2", meaning that "Interest payments and principal security appear

1 *NATS' licence continues unless and until notice of revocation by the Secretary of State. There is a 10 year minimum notice period, and such notice may not be given until 20 years.*

adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time". In quantified terms, Moody's expects less than 0.2 per cent of companies rated as "Baa2" or higher to default on their loans in the course of a year.

1.15 Armed with these sufficiently supportive credit ratings, in August 2003 NATS refinanced most of its debt, replacing the remaining £600 million of the acquisition facility established when the Airline Group bought a controlling share in the Company, with the proceeds of a bond issue. The practical advantage of this refinancing to the Company is that bonds are a cheaper source of very long term finance, and diversify the company's sources of funding, reducing reliance on bank finance.

Stronger finances should contribute towards better performance

1.16 NATS and its shareholders had three main aims when restructuring its debt facilities, and these aims were shared by the CAA:

- To ensure liquidity;
- To regain normal management control; and
- To replace the existing project finance with more appropriate corporate finance.

Achievement against each of these aims is dealt with below.

NATS is now freer to run its own business, but still subject to incentives to perform

Improved liquidity

1.17 As regards liquidity, NATS' senior management were concerned that the PPP had been set up in July 2001 with minimal working capital. They told us that total working capital available to the group at the outset was nearly £20 million in cash and a working capital facility of £30 million. The total working capital facility available to the group at the outset of the PPP was equivalent to about six weeks cash costs, and further money could be made available from other parts of the group to the regulated business, NATS (En Route) Plc (Figure 1). After September 11th the company's access to the £30 million bank working capital facility established through the PPP was barred. Senior management's immediate concern was that the Company might run out of cash early in 2002, triggering insolvency proceedings. Because of these concerns, an interim working capital facility was extended jointly by the Government and the banks as a short-term measure to ensure liquidity, though the facility was never drawn.

1.18 The refinancing package has now established a much stronger buffer of liquid reserves for NATS (En Route) Plc. These comprise:

- A Standby Facility of £16.2 million, funded by NATS' banks;
- A Liquidity Reserve Account of £21.3 million, primarily funded by a loan from NATS' unregulated business;
- A Debt Service Reserve Account of £29 million, primarily funded by banks but incorporating a loan from NATS' unregulated business; and
- Reinstatement of the £30 million bank working capital facility.

Restoring normal Management Control

1.19 With the refinancing, NATS' Management have more control over their business. This is in part because bank restrictions are reduced. For example banks' approval of the Company's business plan is no longer required and the requirement for bank approval of major expenditure or disposals has been relaxed. But also, with the completion of negotiations, senior officers such as the Chief Executive and Finance Director have been able to turn their undivided attention to the running and development of the business, as opposed to dealing with banks, the regulator, shareholders and advisers over the refinancing terms.

Transition to corporate finance

1.20 As a result of the refinancing, NATS now also has more assured access to its £300 million Capital Loan facility which is earmarked to fund much of the Company's £1 billion Investment Programme over the next ten years. Like the Working Capital facility, this loan was unavailable to the Company following September 11th because the Company could not clearly forecast that it would be able to meet the repayments in the longer term. In this context, NATS' management decided to defer major elements of the capital expenditure programme.

1.21 The facilities provided by the banks have now been restructured to make them more like corporate loans than the previous project finance structure, whilst ensuring that the banks could still syndicate them. In order to retain access to these facilities NATS now has to meet less onerous financial covenants. In particular its finances are now required to comply with fewer debt cover ratios. The tenor of the facilities was reduced from 20 years to 10 years in the case of the Acquisition Loan and five years for the Capital Loan and Working Capital facilities. While long term forecasts are still required, breaches of financial ratios in future years can now be rectified through notional drawings on the newly created Liquidity Reserve Account and Standby facility, thereby improving the robustness of the financial structure. Furthermore, the financial forecasts that the company is required to provide will, in the event of a dispute, now be reviewed by an independent arbitrator on these matters, rather than by a bank nominee as was previously the case. There has also been a loosening of the bank oversight regime, giving NATS' management more flexibility and control in the running of the business. For example there is no longer a requirement for the banks' Technical Adviser to have approved the Company's Business Plan.

1.22 The Banks' margins and fees were also revised. These are now determined by the company's credit rating in the investment market, so that they are dictated by the company's future performance rather than being subject to a pre-defined upward ratchet. As a result margins and fees payable prior to syndication of the bank facilities were reduced. The banks also agreed that the new investment from BAA plc and the government would rank equally for interest payments with bank debt in some circumstances.

A supportive new shareholder

1.23 Many participants in the refinancing expressed their approval to us that BAA plc has become a shareholder in NATS. As the main operator of Airports in the UK, including Heathrow, Gatwick and Stansted, BAA has a major strategic interest in ensuring that NATS prospers and expands its capacity to match growing capacity at airports. BAA should also bring experience in the management of major infrastructure projects that could be of great value to NATS.

Maintaining an incentive on NATS

1.24 The Department told us that by acting as a responsible shareholder in NATS, they and the Treasury were concerned not to set unhelpful precedents for the Company, its banks, regulator or the other shareholders by weakening future incentives on the Company to perform. The basic structure of the PPP, particularly incentive-based price regulation, has been maintained and the Government declined to commit themselves to being prepared to inject new shareholder funds until the Company itself had demonstrated that it had done all it could to resolve its difficulties (described in more detail in Part 3), including seeking a new investor.

The deal has unlocked the investment programme

1.25 Within days of the agreement on the Composite Solution for NATS, the Company announced the commencement of its delayed Investment Programme, beginning with a ten-year £127 million programme for new radars at 20 sites across the United Kingdom. NATS believe they have been able to strike a better deal because of the long term certainty of financial resources provided by the new solution, beyond that achieved before the Public Private Partnership. Further announcements in April 2003 included collaboration with the air traffic control services of Germany and Spain to develop an interoperable replacement for NATS' current vulnerable flight data processing system at West Drayton which caused major disruption to flights in and out of the UK in Summer 2002.

1.26 During the crisis of late 2001, NATS obtained permission from the Secretary of State for Transport to defer indefinitely the 2007 completion date for the New Scottish air traffic control Centre in Prestwick. Following the successful refinancing, NATS announced in October 2003 that work on the Centre was to recommence early in 2004, for completion by 2009.

1.27 Besides reinstating these vital core projects, NATS has been able to complete its programme of voluntary retirements, which was designed to reduce the Company's overhead burden, and to further progress the relocation of its Headquarters and administrative offices from London to its new consolidated site at Swanwick near Southampton.

There are good prospects for improved performance

Quality of Service is improving

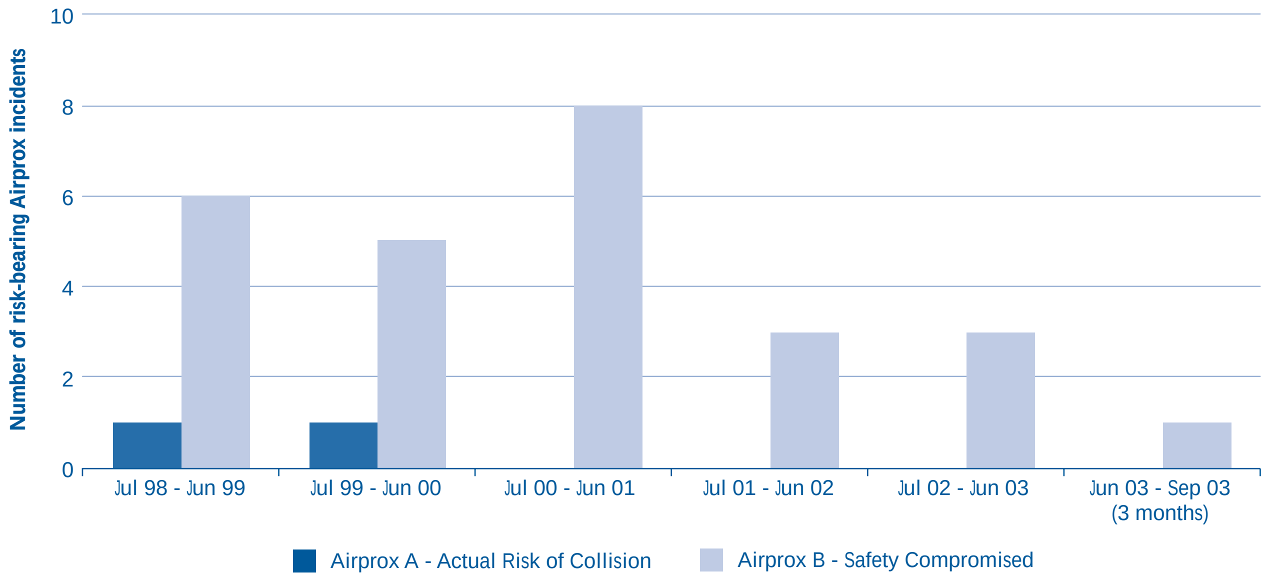
1.28 As explained in our previous report, the main aspects of air traffic control performance monitored by NATS, its customers and its regulators, are safety and the extent of delays to flights due to air traffic control.

NATS' good safety record has been sustained

1.29 The Civil Aviation Authority's Safety Regulator has examined the safety performance of NATS since the PPP. The key measure, the number of Air Proximity Incidents, is defined as a situation in which, in the opinion of a pilot or a controller, the distance between aircraft, as well as their relative positions and speed, have been such that the safety of the aircraft involved was, or may have been, compromised. From the Authority's own assessment of such incidents **(Figure 5)**, NATS' overall performance under the PPP appears to be comparable with, if not better than, that achieved previously.

5 The number of risk-bearing air proximity incidents involving a NATS contributory factor

There has been no discernible deterioration in the rate of safety incidents since the PPP was signed in July 2001.

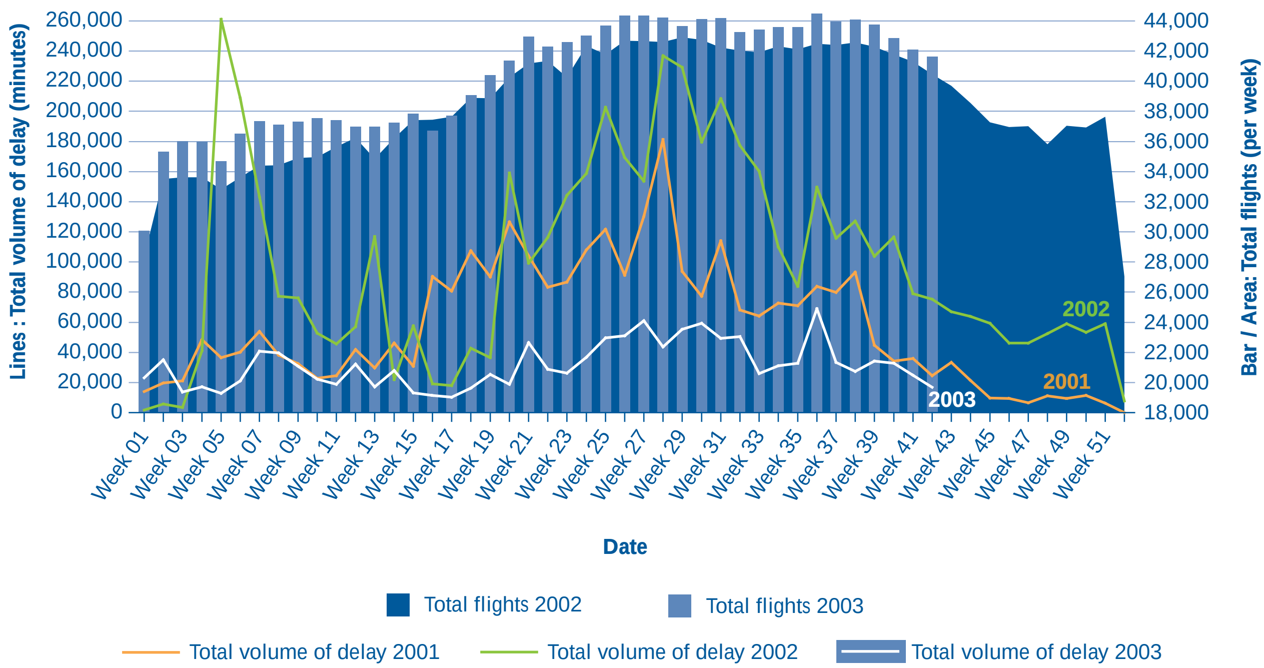


Source: Civil Aviation Authority

6 Key trends in flights and delays

After a bad 2002, NATS' performance in minimising flight delays has improved considerably despite record traffic levels.

UK movements Vs volume of UK NATS attributable delay



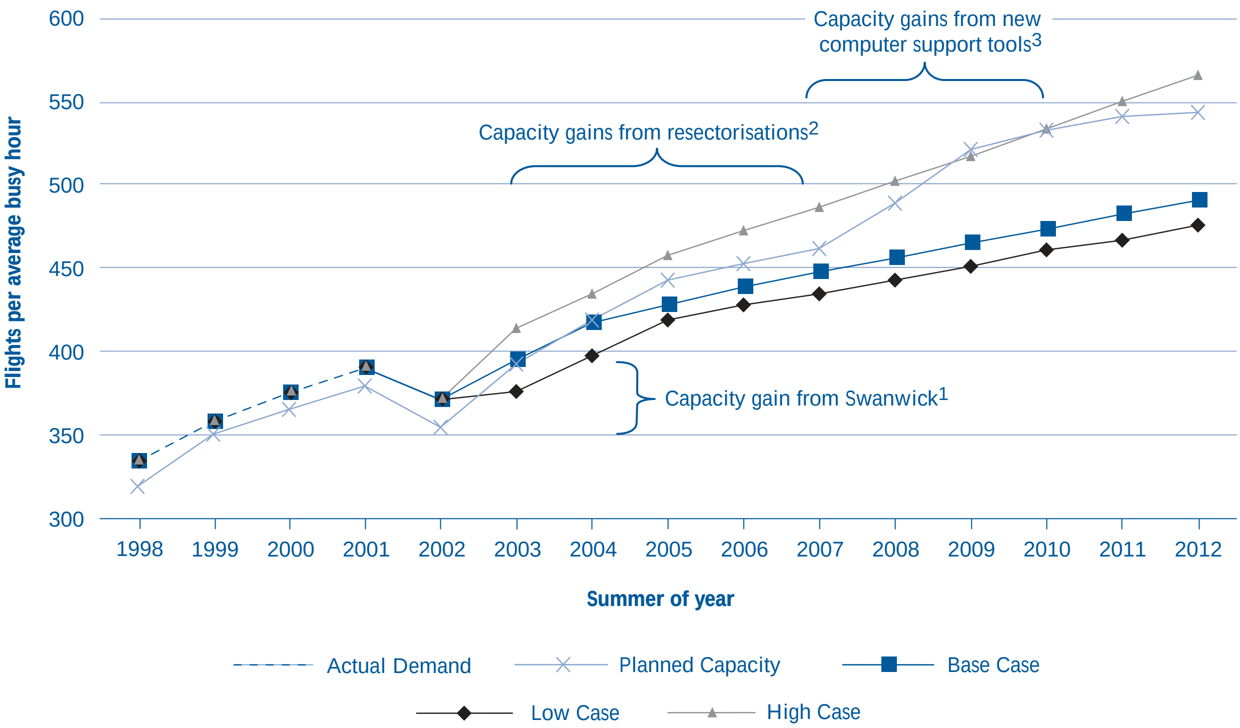
NOTE

Though the total number of flights has risen in 2003, growth has mainly been in relatively small aircraft flying to Europe, which yields less income for NATS than do transatlantic flights, which have reduced.

Source: Data from NATS

7 The growth in capacity proposed in NATS' 2003 Business Plan

NATS' business plan proposes increases in capacity to deal with a high rate of traffic growth.



NOTES

1 For example, providing more controllers per sector.

2 Capacity gains from splitting the airspace into smaller sectors.

3 New computer tools to carry out some of the functions currently done by controllers.

Source: NATS

1.30 NATS' controllers are also able to freely report occasions on which they consider that their workload in terms of aircraft being handled has been excessive. The number of overloads reported by controllers (43 between January 2002 and June 2002), in the first five months following the opening of the new En-Route Centre at Swanwick, was significantly higher than the norm. But the rate of reporting has now settled back to a figure consistent with the five year rolling average. Initial indications are that many reports resulted from unfamiliarity with the new workstation environment, minor technical issues, and some instances of heavy traffic (above agreed traffic flow rates) which did not however, result in safety being compromised. Since the PPP, no Air Proximity events have resulted from controller overloads.

Delays to flights are reducing

1.31 Our previous report on the PPP was written at a time when NATS was still struggling with the operational and organisational changes, including the consequences of moving its Air Traffic Control operations for Southern and Central England to its new centre at Swanwick near Southampton. Disruption was compounded by the effects of breakdowns in key computer systems at its West Drayton centre, with average delays per flight to and from London peaking at over 4 minutes. In Summer 2002, half of all Europe's Air Traffic delays were concentrated in London (compared to 17 per cent in 2001).

1.32 Since then, performance has greatly improved as controllers have grown more familiar with the new systems at Swanwick, as computer systems have stabilised, and as shortages of staff have been addressed through a range of measures, including the use of additional voluntary attendances and earlier starts to morning shifts. Delays are now less than one minute a flight, compared to nearly three minutes in 2002.

Looking ahead, NATS' investment programme is designed to cope with the possibility of higher than expected growth in traffic over the next ten years. **Figure 7** shows NATS' plans for increases in capacity against peak hour forecasts of flights in the busy flight area around London and the South East. The base case demand line depicted has been updated by NATS from that shown in the NATS' 2002 and 2003 Business Plans. The high case and low case demand lines have not yet been updated and are expected to be revised down. So the apparent risk of a shortfall of capacity until 2009 should not be as significant as it appears.

Price changes appear reasonable

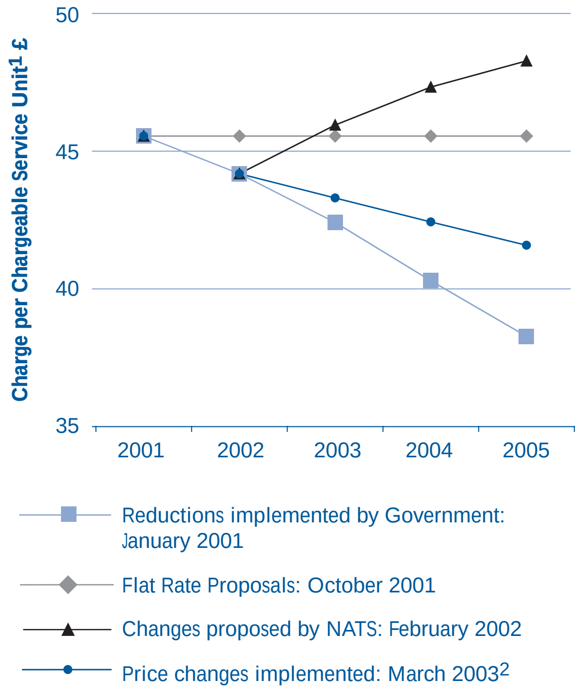
1.33 As a contribution to giving NATS more robust finances, the Civil Aviation Authority has agreed that the Company's prices should fall less in real terms than the price cuts originally planned for the first five years of the PPP. These concessions will cost airlines some £100 million over the period 2003-2010. We have considered these price changes in the context of NATS' original proposals for price increases, relative prices across Europe, and the extent of Airline support for them.

1.34 As shown in **Figure 8** below, the price changes that have been granted are less generous to NATS than initial proposals put forward by the Company following September 11th. The Authority told us that they felt that these initial proposals in February 2002 would have restored NATS' finances largely at the expense of its customers, and did not meet the Authority's perception of a truly composite solution.

1.35 Our previous report showed that in 2001, before the PPP changes took effect, NATS' charges to Airlines for en route air traffic control were the highest in Europe. Comparisons between international charges are difficult due to different approaches to charging and to cost recovery. In addition, figures should be interpreted with caution since the picture varies from year to year due to fluctuating exchange rates and as under-recoveries or over-recoveries of cost are adjusted in later years. Figures from the published charges (the amounts actually paid by air users through the European air traffic authority Eurocontrol) show NATS to be the fourth most expensive provider **(Figure 9)** after Switzerland, Germany and Benelux. This appears to be broadly consistent with Eurocontrol's latest analyses of the cost effectiveness of European providers[2]. Generally, existing cost effectiveness measures are based on costs per kilometre with no account taken of the complexity of airspace. What is not disputed is that after the commencement of the PPP, NATS' regulated prices improved relative to those charged elsewhere in Europe, where operators raised their charges following September 11th by 12 per cent on average in 2002.

8 Changes to NATS' prices to Airlines

Price changes were less generous than those proposed following September 11th.



NOTES

1 This is the Charge per Chargeable Service Unit - the unit of flight activity on which European ATC providers base their charges to airlines. One service unit is generated by a plane of 50 tonnes flying for 100km through UK airspace. Charges are expressed in Constant Prices.

2 The price changes implemented in March 2003 involve demand risk sharing. Hence the actual price is dependent on demand. The prices shown here represent those which would result if demand were as in NATS' November 2001 Base Case.

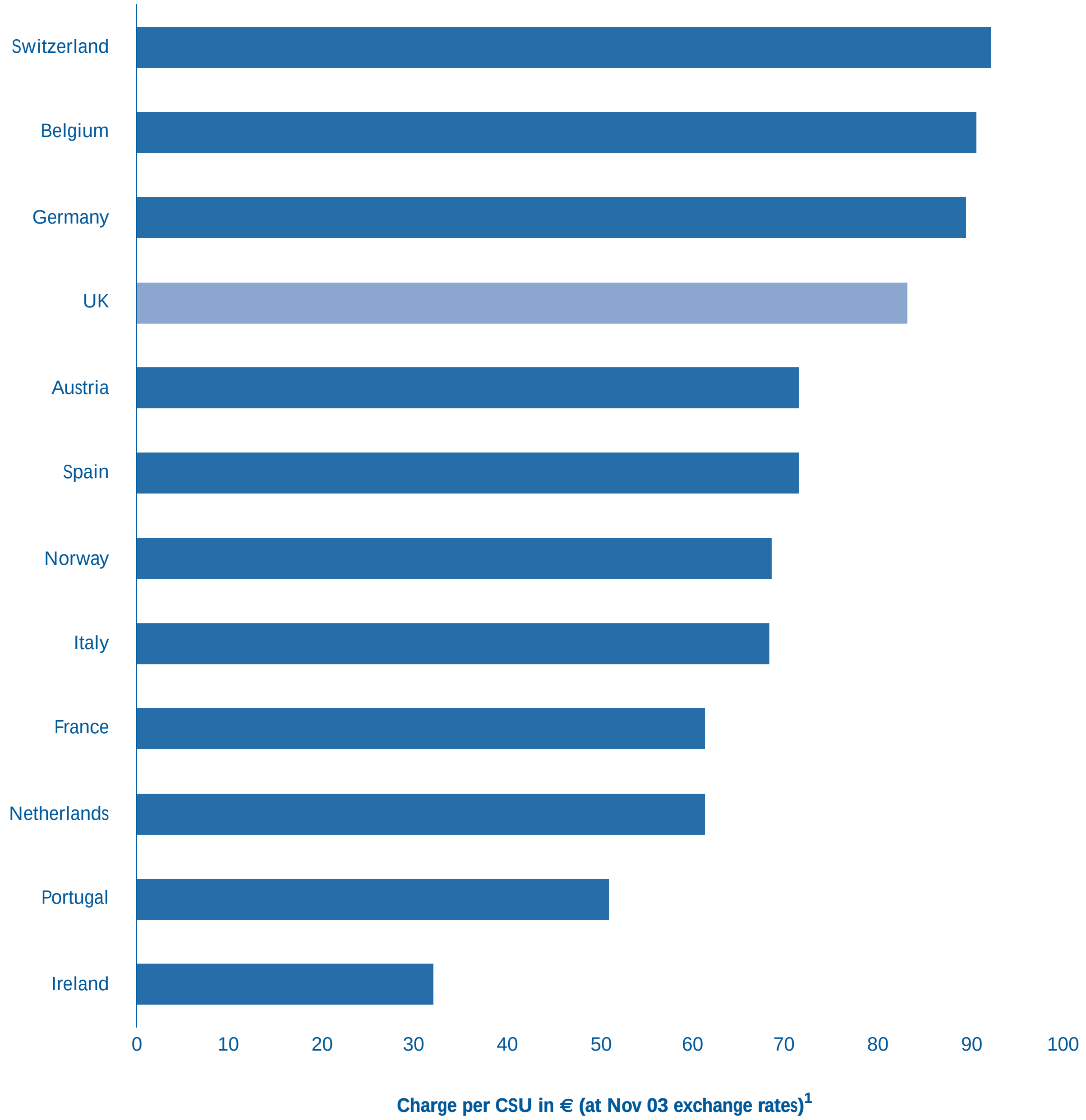
Source: NATS

1.36 In deciding to relax its caps on prices, the Civil Aviation Authority requested and took into account representations from the aviation industry. Most of the twelve airlines that responded supported the Authority's proposal to revisit the price cap, but three airlines questioned the need for increases and strongly expressed the view that any increases should be tied to improvements in NATS' quality of service. The Authority responded to this argument to some extent by increasing the financial incentives on NATS to reduce delays. Amongst other changes, the maximum penalty for severe delays has been doubled to £10 million a year, about two per cent of turnover. Based on its much improved performance to date in 2003, it appears that NATS may not be subject to penalties this year.

2 *Report by the Performance Review Unit, Brussels, September 2003.*

9 NATS' charges to Airlines - the European perspective

The UK's charges for en route air traffic control will be the fourth most expensive in Europe in 2004.



NOTE

1 This is the Charge per Chargeable Service Unit - the unit of flight activity on which European ATC providers base their charges to airlines. One service unit is generated by a plane of 50 tonnes flying for 100km through UK airspace.

Source: NATS

Part 2

The Department achieved its negotiating objectives

2.1 This part of the report examines the achievement of the Department's objectives during the refinancing of the NATS PPP, in the context of the alternatives had the negotiations failed and of the wider implications for Public Private Partnerships.

The deal avoids highly uncertain alternatives for NATS that all stakeholders considered could be worse

Continuing the PPP was better than administration for all parties

2.2 For the Government and the Airline Group, administration would have meant that the value of their existing equity stakes in NATS would have been at severe risk and that the future development of the Air Traffic Control System could have been prejudiced. 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 Civil Aviation Authority has duties under the Transport Act 2000 to further the interests of users of NATS' services and to secure that the Company will not find it unduly difficult to finance its activities - responsibilities that would have been difficult to discharge if NATS were being run by an independent Administrator.

2.3 So each of the main participants in the negotiations to restructure the finances of the NATS PPP had reasons to want to avoid the Company going into administration. But any participant signalling that it would ultimately be unwilling to let the Company go into administration would have found itself in a poor negotiating position. The Department's negotiating tactics towards the other participants were therefore vital.

Continuing the PPP was better than public ownership

2.4 If an administrator was unable to find a suitable new private sector investor for NATS, a potential outcome could have been that the Company would have eventually returned to public sector ownership and management. Although there was legal provision for administration, the Department did not want this to happen because it would have reversed the PPP process and returned NATS to Government ownership and control. This in turn could have meant that NATS' customers would have had to shoulder the entire financial burden. More widely, it would also have had adverse consequences for the wider initiative to develop the use of Public Private Partnerships in the public sector.

Continuing the PPP was better than "do minimum" scenarios

2.5 During negotiations with NATS in mid-2002 and following the negative initial response by the Civil Aviation Authority to the Company's application for an interim review of the price caps, its four investing banks raised the possibility that they might pursue other ways of improving the Company's financial position. These included;

- Curtailing future capital and operating expenditure to the minimum required for the purposes of meeting statutory obligations and retaining the operating licence, without provision for expansion of the air traffic control service; and
- Disposing of parts of the business, individual assets and properties.

2.6 It is not clear whether this was a realistic threat. For example, the legislation (including the licensee's statutory duties under the Transport Act 2000), the terms of the PPP and the Company's licence restrict its freedom to shed any assets required to keep a viable Air Traffic Control system in being. Nor did it seem likely that the banks would have wished to be in direct control of such a safety-sensitive business. However, the Government, the Airline Group, the Civil Aviation Authority and NATS itself were all concerned to prevent the Company being placed in such a situation from which it could not move forward.

The Department concluded that a further investment in NATS would be commercially justifiable

2.7 The prospect that the Government would be asked to make an additional investment in NATS emerged soon after the events of September 11th. The Company stated in December that its shortfall in funds, until the end of 2005, would be between £235 million and £434 million, depending on future trends in traffic, and that to provide a realistic cushion against future shocks as well implied a total requirement for some £600 million over that period. After finding some £200 million of savings internally, and assuming that the CAA would deliver some £100 million through increased prices, NATS estimated that this left a sum of around £300 million to be contributed by shareholders, including the government, in the form of additional equity or quasi-equity.

The Department validated the amount required

2.8 The Department's initial response in late 2001 was that the Government would only act as a responsible shareholder on the basis that all other stakeholders including the Company, the banks, the other shareholders and the Company's customers had also made a contribution, and would not expect to contribute until the extent of the decline in traffic had become clearer. Throughout early 2002 these matters were clarified, and in July, NATS submitted a formal business case for a total investment of £130 million, of which £65 million would be from Government. In evaluating this business case, the Department's advisers, Credit Suisse First Boston, stated that it represented a compelling case for investment, whilst noting that validating the amount required is not an exact science. The investment would unlock other essential elements of the Composite Solution and generate an annual real return to the taxpayer of eight per cent. In particular, the fact that the CAA would not relax the cap on NATS' prices without more equity on the balance sheet was "the single most important argument in favour of providing additional investment".

The Department insisted they would invest only on the same terms as a new investor

2.9 The Department informed the other participants in the process that they would provide additional investment in NATS only on the same terms as that made by the private sector. This was important because:

- Matching additional private sector investment in NATS pound for pound, broadly reflected the existing split between public and private sector share capital;
- Ensuring that the government's investment was on the same terms as the private sector would provide added assurance that the detailed terms are robust and strictly commercial; and
- Demonstrating that the terms are strictly commercial protects government's investment against a challenge to the European Competition authorities on grounds of state aid.

2.10 The new investor in NATS, BAA plc, was selected following a competitive process run by NATS in consultation with the Government, the Airline Group and their respective advisers. A feature of the BAA and Government investment in NATS is that only £5 million of each investor's £65 million investment is in the form of pure equity. The rest is in the form of loan notes on which interest payments will rank before dividends to existing shareholders like the Airline Group. In addition the loan notes issued by NATS' regulated business will rank equally for interest payments with bank debt in most circumstances.

The deal has defended the value of the Government's pre-existing investment in NATS

2.11 The Department's advisers, CSFB, told us that one of the key benefits of the refinancing has been to restore value to the government's original investment in NATS. Had the Company gone into administration the Government's shareholding could have become worthless. The current value of this stake is still subject to audit. We heard from the Airline Group that five of its seven airline members have maintained the value of their original investment in NATS in their audited accounts. Two, Easyjet and British Airways, have written down their investment, in the former case to Nil.

The deal is compliant with general PPP policy

Government has acted as a responsible shareholder

2.12 From an early stage in negotiations the Department defined the position it would adopt as a responsible shareholder. This meant:

- In principle, matching additional private sector investment, by amount and in detailed terms; and
- Supporting the work of the government's non-executive Partnership Directors within the Company, who themselves played an active role in the Company's negotiations with banks and potential investors.

2.13 We found evidence during our examination that NATS' four investing banks had on occasions complained to the Department about the stance of the Civil Aviation Authority during negotiations. The banks wanted to see more concessions from the economic regulator that would relieve the financial pressures on the Company, and so reduce the need for concessions by the other participants. The banks told us that they had been looking for indications that the Authority would consider a review of the price cap favourably. They considered the initial response from the CAA was extremely negative and that it was wholly appropriate for them to make their views known to the Company and to its shareholders. They became more confident that the CAA appreciated the issues surrounding the company's finances when in mid-summer 2002 the CAA appointed the Royal Bank of Scotland as its financial adviser.

2.14 The Department themselves had to manage a potential conflict of interest since as well as being a shareholder in NATS, they are also a sponsor of the Authority which determines NATS' prices and as a consequence in this case, the level of new shareholder capital that was required. Even though it has no locus to intervene in the economic regulation of NATS by the CAA, the Department had to be careful not to apply pressure, or to be perceived as applying pressure on an independent regulator, since the credibility of independent economic regulation is an important element of the Government's economic policy. Through interview with regulatory officials, and review of documentation, we have found no evidence to suggest that the Department had applied pressure on the Authority.

The deal avoids the setting of a poor precedent

2.15 In setting their objectives for dealing with the financial difficulties at NATS, the Department recognised that any settlement could have implications for wider government policy for Public Private Partnerships. They were conscious of the "moral hazard" risk; that if they were perceived to be rescuing the company this could create a poor precedent for other Public Private Partnership deals. It would be a serious matter if private sector companies received the impression that the Government would ultimately "bail out" partnerships that got into trouble, even where vital public services are at stake. The Department, backed by the Treasury, stated that while the other participants may have perceived the Government as the first in line to provide a solution, this was not the Government's view. They had been willing to engage in a process but not to underwrite the funding gap. This position was made clear at all times when the Government was put under pressure to act otherwise.

It avoids difficulties with state aid

2.16 By investing only on the same terms as the private sector, the Department prevented any question arising of state aid which would have to be notified to and approved by the European Commission. They also successfully addressed, through the voting and other arrangements associated with the investment, the competition issues that might have been raised in connection with BAA plc having a stake in NATS.

The deal preserves the quantum of the Employees' stake in NATS

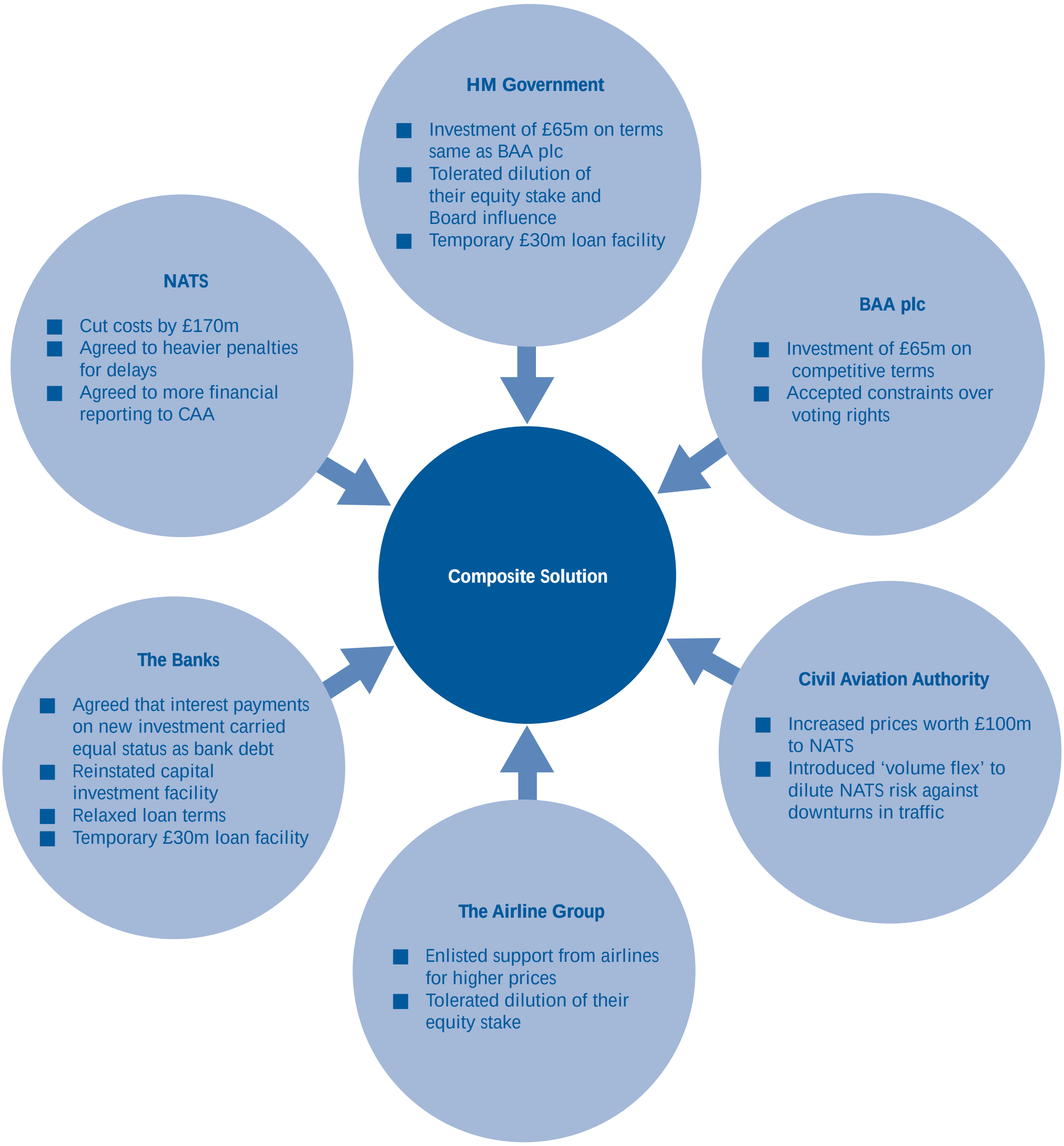
2.17 When the public private partnership was established, five per cent of the ordinary shares were vested in an Employees' trust to give the staff a direct financial stake in the success of the Company. The Government, BAA and the Airline Group agreed that the restructuring of NATS should leave Employees with the same proportion of the shares. Each shareholder gifted shares to the Employees' Trust, in strict proportion to their share holding. In the case of Government, the value of the shares gifted was £257,198.

Government met its objective of achieving contributions from each stakeholder

2.18 The Department and the Treasury did not adopt an objective of requiring broadly equivalent contributions from each of the participants. Given the differing means of the parties, with members of the Airline Group being afflicted by the same downturn in aviation that had damaged NATS, absolute equality was probably not achievable, and could have prejudiced achievement of a deal. But the Department recognised that a visible process of "give and take" in which there were contributions by all participants would be important to reaching a solution that each key player would support. For example, the Civil Aviation Authority demanded concessions from the banks and the shareholders as a condition of relaxing the price caps. A summary of the contributions made by all parties is at **Figure 10**.

10 Main Contributions to the Composite Solution

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



Part 3

The effort and expertise involved contribute to assurance that the deal is fair

3.1 This part of the report identifies the reasons for the protracted nature of the negotiations leading to the Composite Solution and the costs incurred by each of the parties involved.

Avoiding an overly protracted process was important to NATS

3.2 As referred to in our previous report the Company's financial difficulties had prevented it from making a start on its ten-year Investment Programme to increase the capacity and performance of the air traffic control system; the key objective of the PPP[3]. In oral evidence to the Committee of Public Accounts in November 2002 the Chief Executive of NATS said that despite the lack of external funding, the Company had used the year well, undertaking project planning and improvements to project management. Some investment funds had been generated internally, but he considered that the solution had to be achieved within "the next few months" to avoid a risk of demand exceeding capacity in the future.

3.3 The longer the Company lacked access to external funding, the more serious the consequences would be. In such difficult circumstances the Company faced a growing challenge in retaining key managers and in maintaining staff morale. A real risk of industrial action over pay and terms of employment was only averted with some difficulty in September 2002. Important procurement contracts, including a radar replacement programme, were deferred, and the Company was in a weak position to progress collaborative projects with other Air Traffic Control authorities while major uncertainty hung over its future finances.

Getting to a deal still took 18 months

3.4 Though each of the participants had an interest in reaching a solution without undue delay, it took some 18 months, from mid September 2001 to March 2003 to agree a deal, although the interim working capital facility was in place by early 2003. The main phases of the project are shown in **Figure 11**.

In some respects the costs and timescale were understandable

The undertaking was complex

3.5 Assembling the Composite Solution for NATS was a very complex change programme which required consistent progress on five parallel fronts, each of which were major projects in their own right. These were:

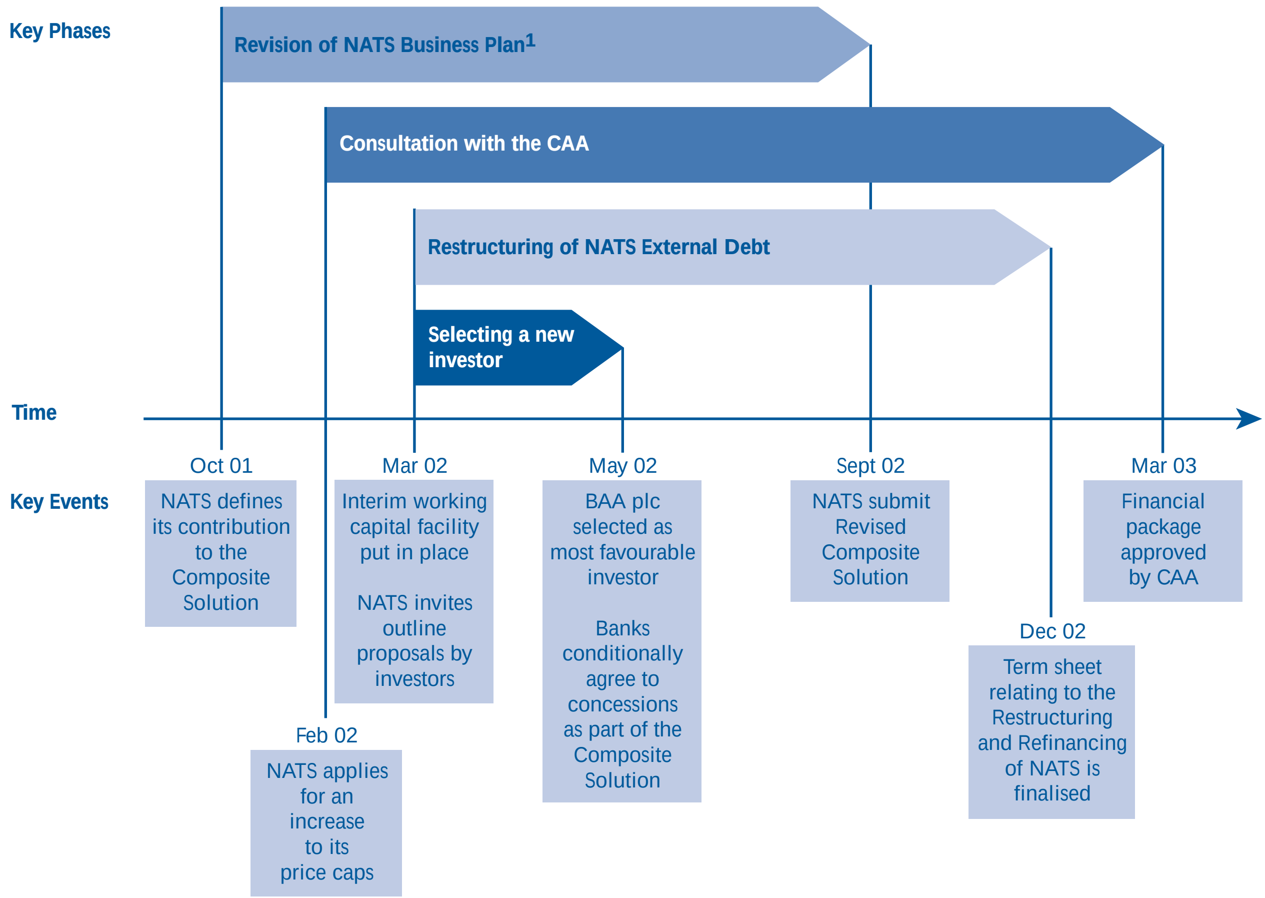
- A cost reduction initiative within NATS [paragraphs 3.10 - 3.11];
- Implementation of an interim solution, a temporary working capital facility;
- Identification and selection of a new corporate shareholder [paragraphs 3.21 - 3.23];
- Extensive revisions to NATS' three major bank facilities for the Company's acquisition, working capital and capital investment [paragraphs 1.14-1.18]; and
- Negotiations with the Civil Aviation Authority following NATS' request for the relaxation of the price caps and other changes in the regulatory framework [paragraphs 3.13-3.14].

One of the Government's Partnership Directors told us that in his wide commercial experience this was the most complex programme he had ever encountered, on a par with the most challenging mergers and acquisitions.

3 *Paragraphs 3.36 - 3.39, The PPP for National Air Traffic Services Ltd, HC 1096, 2001-02.*

11 The main phases in the restructuring and refinancing

Key phases in reaching the Composite Solution overlapped and were interdependent.



NOTE

1 NATS' revised Business Plan was completed by March 2002 and was refreshed in the period from Sept 02 to March 03.

Source: National Audit Office

3.6 The response of Air Traffic Control providers in other countries to the downturn in traffic were much simpler. Within Europe, most providers are not subject to the discipline of economic regulation and simply raised their charges to airlines in 2002 and 2003. The world's only other privatised air traffic control service, NavCanada, is also not subject to economic regulation but like NATS it is controlled by the aviation industry. By January 2002 it had implemented a balanced programme of spending cuts and drawing on reserves in response to the downturn in traffic, which limited price increases to airlines to six per cent. NavCanada, established in November 1996, had had much longer than the NATS PPP to build up reserves before September 11th.

Events at Railtrack set a difficult context

3.7 The Department's negotiations over NATS took place against a background of tense relationships with private sector financial institutions over Railtrack. In October 2001 the Secretary of State for Transport applied to have Railtrack put into administration, from which it emerged a year later. The Department promoted Network Rail as the vehicle to get Railtrack out of administration and was involved in negotiations with banks about the terms on which they would extend finance to it. These negotiations were taking place at the same time as negotiations on NATS refinancing, probably slowing the process while the banks considered whether there was any potential read across.

Many parties had to play their part, which took time and money

All parties saw advantage in waiting for others to act first

3.8 There is a natural tendency in all multi-party negotiations for each participant not to want to be the first to commit to making a contribution. The Department avoided committing public money until the scale of NATS' cash shortfall was clearer, and until the outcome of the CAA's interim regulatory review process was known. They and their advisers identified that, due mainly to recent receipts of fees from airlines, NATS should have had sufficient cash to meet its short term needs until at least the first quarter of 2002. The Department and the banks put in place a temporary loan facility of £60 million. In the event, NATS did not need to draw on this facility at all, because

- its worst case forecasts in the immediate aftermath of September 11th proved to have been over-cautious,
- of its vigorous cash management, including cost reductions, the deferral of non-essential operating and capital spending, and
- intra-company loans from more cash-rich parts of the Group to the regulated business.

NATS so tightly conserved its cashflow that up until the Composite Solution was complete it had not needed to draw on the short-term facility provided by its Banks and the Government. It had accumulated £100 million in reserves of which some £32 million was available within the regulated business.

3.9 Deferring the injection of Government finance had other advantages:

- Negotiating the temporary loan provided a useful lever to use in negotiations with other parties. The Department and the Treasury gave their agreement to providing NATS with a loan only on condition that the Airline Group agreed in writing to be supportive in the longer term restructuring of NATS' finances, particularly by not obstructing the insertion of a new investor or the application to the CAA for increases in NATS' charges to airlines.
- It gave sufficient time for the long term effects of the traffic downturn to become clearer, to inform the longer term restructuring. Within a few months it became evident that this would not be as severe as NATS' initial worst case estimates.

NATS first had to identify the contribution it could make

3.10 In October 2001 NATS was the first of the participants to define its contribution to the Composite Solution, through a programme of spending cuts and deferrals, much of which represented an acceleration of measures already identified in the Airline Group's first Business Plan for NATS. Government's Partnership Directors provided the Department and Treasury with assurance that the savings were a reasonable sum at reasonable risk, and that more stringent cuts would raise industrial relations issues. Indeed by late 2002, NATS' savings had reduced from £200 million to some £170 million, due in part to a less tight wage settlement for staff than previously expected.

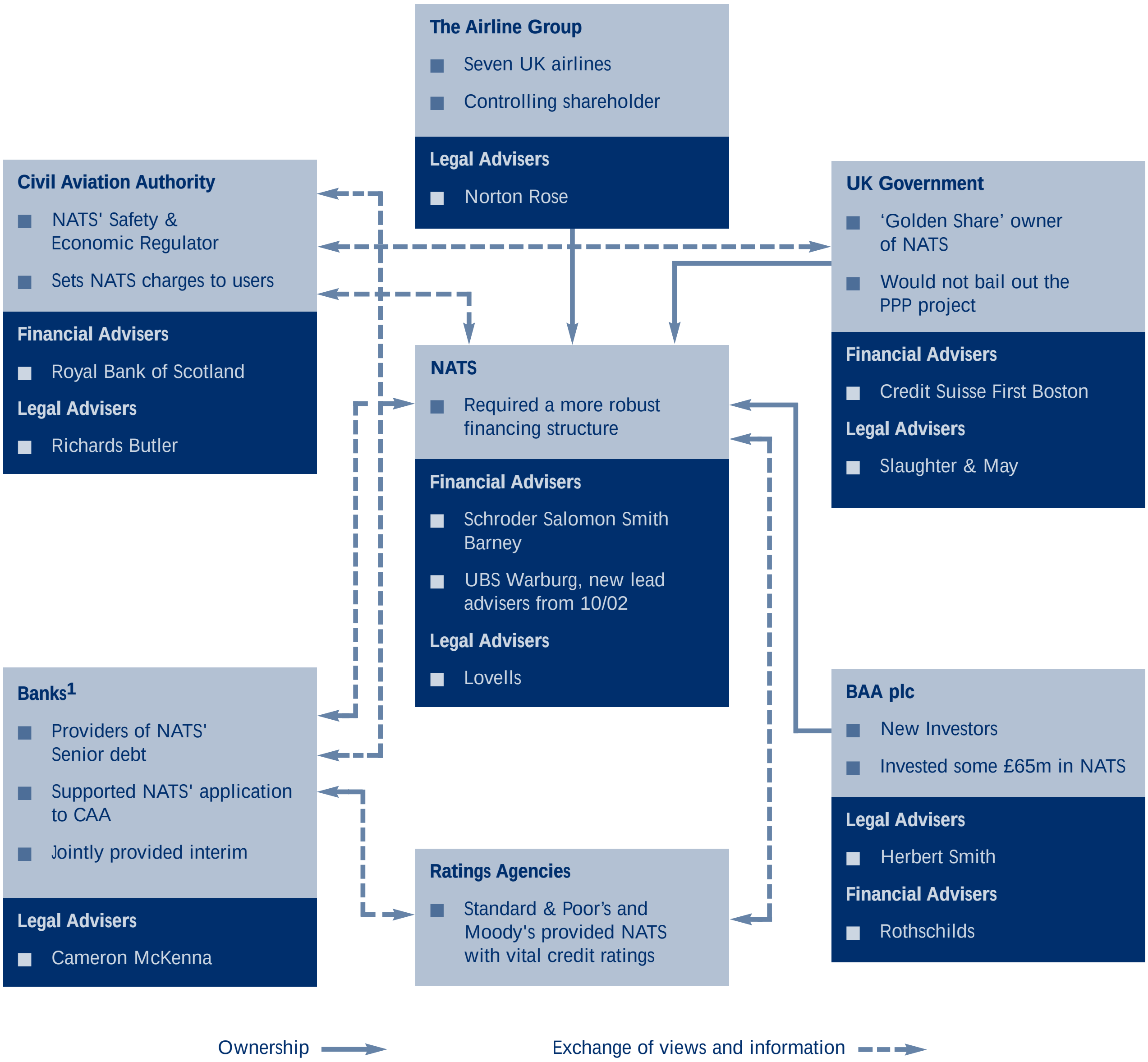
3.11 One of the main elements in NATS' cost savings programme is attributable to its plans for fewer air traffic controllers compared to the major increase proposed in the Airline Group's original proposals for the PPP. The Airline Group had intended to raise the total number of Controllers from 1939 in 2001 to 2400 by 2010, to raise the capacity of the system. The new Business Plan provides for an increase to only 2079 controllers by 2010. NATS does not consider that this will prejudice its plans to enhance the capacity of the system. Following a review, it decided that 2400 controllers would be unnecessary given the current business plan and reduced traffic levels since September 11th. NATS intends to reduce the number of traffic control centres from four to two, and to automate some functions of controllers in the period 2006-2010. Changes in working practices, including earlier starts to morning shifts, will also help. The revised figure of 2,079 still represents an increase and is also more realistic in the light of the Company's finite training capacity.[4]

3.12 NATS and its shareholders also considered whether the Group should raise funds by selling off its unregulated business, NATS (Services) Ltd. But they concluded that this would not have been a sufficient answer in itself. NATS (Services) is not a big business and would not have raised sufficient funds to address the funding deficit.

4 *HC 1096 2001-02 The PPP for National Air Traffic Services Ltd, Paragraph 3.12.*

12 Key Players in the refinancing of NATS

Many parties had to play their part, which took time and money. The stance of each of the main parties is explained in more depth at Appendix 4.



NOTE

1 Moving forward following the refinancing, the banks will be replaced as the principle creditor to the company by MBIA, an insurer which provided a guarantee for the bonds issued.

Source: NAO

In deciding whether to allow higher prices, NATS' regulator had to follow due process

3.13 The role of the Civil Aviation Authority as economic regulator of NATS is governed by the provisions of the Transport Act 2000 and by the need to follow a defensible and transparent decision-making process. When the PPP was concluded in July 2001 the Department, in consultation with the Authority, set price caps for the five years ending in 2005/2006. This widely-used approach to regulation enables both regulated companies and their customers to plan with relative certainty. To reopen the price caps within this five year "control period" is therefore an unusual action which can only be taken in the light of exceptional circumstances, whether as defined in the Company's licence or more generally. The Transport Act, in common with similar legislation, does not explicitly provide for a mid-term review nor define what would constitute an exceptional circumstance, but places a duty on the regulator to act in a way which does not make it unduly difficult for NATS to finance its licensed activities.

3.14 In October 2002, having evaluated submissions by NATS with the help of their own financial advisers from the Royal Bank of Scotland, the Authority came to a provisional conclusion that there were grounds for an exceptional contribution by customers. They then had to allow time for a further period of consultation with interested parties, primarily customers, some of whom objected to the contribution. Responding to concerns expressed by many of NATS' customers during consultation, in December 2002 the Authority linked the price increases to a strengthened regime of financial incentives on NATS to minimise flight delays. The late introduction of these penalties meant that further time was spent in negotiations and in work to confirm that NATS' new financial structure would remain robust. Once this work, and formal consultation, had been completed, the Authority confirmed its decisions on charges in March 2003. The Authority acknowledged to us the long duration of the process, but said that they could have reached a provisional conclusion much faster if NATS had not previously put forward a number of proposals which, in the Authority's view, were not sufficiently realistic.

The Airline Group would not make a further investment

3.15 It became clear within a very few weeks after September 11th that the Airline Group were unwilling or unable to invest more money in NATS as might normally be expected of a responsible shareholder. We found no evidence that NATS or the Department had subjected this presumption to detailed debate or quantified analyses of Airlines' inability to pay. It was taken as self-evident against a background of the global aviation industry undertaking severe cuts in flights, staff and investment in a frantic effort to maintain solvency.

3.16 We met representatives of the Airline Group to better understand the reasons for their position. They stated that after September 11th, Group members were in dire financial straits and could not afford to subscribe additional capital. They put this in the context of the earlier difficulties experienced by the Group in putting together the funds for their initial investment in the PPP, in July 2001. Though the stated ethos of the Group was equal shares for equal members, not all partners had been able to commit the necessary funds and British Airways had had to fund an additional £15 million loan to help complete the transaction. This background understandably provided a difficult context for injecting further funds during the Composite Solution.

3.17 The motivation for all Airline Group members in investing in NATS was not to make a commercial return, but to ensure the future of a key service to airlines and to keep it out of the hands of a strictly profit-making operator. But investing for the common good also benefits non-investors. Airline Group members felt that it would be appropriate for overseas airlines, who use UK airspace a lot more than several of them, and stand to benefit substantially from the projected improvements in service levels to users, to subscribe to the refinancing. Unfortunately no practical way could be devised to bring them to the table. The Airline Group fully recognised that if sufficient new equity could not be found somewhere, administration would hold risks for them; notably the loss of majority control to a new investor, or the loss of PPP benefits to airlines generally and investments in NATS should the Company revert to Government ownership.

3.18 The Department and their advisers consider that they had pushed the Airline Group quite hard to raise their investment in NATS. They were aware that not all carriers were badly affected by the events of September 11th. The budget carriers saw an increase in market share and in passenger numbers. The Department's advisers considered this but noted that Easyjet had written off its stake in NATS and could not be expected to increase its investment. They also noted that Ryanair, another relatively prosperous carrier, had remained resolutely outside the Airline Group. Low cost airlines achieve their profitability in part by avoiding investments that do not show a solid commercial return. The advisers consider it most unlikely that Easyjet would have made a loan to NATS of the type made by British Airways when the PPP was established in 2001. Moreover, there was serious uncertainty and pessimism in the airline industry in the months following September 11th that added to Airlines' caution.

3.19 The Airline Group has retained operational control of NATS through a majority of the 15 directors. They still hold five director posts directly, nominate an international airline representative and select the chairman and the three executive directors (with some involvement of other shareholders in the selection, but with effective Airline Group control). Another two seats may be filled by Airline Group nominees at any time.

3.20 The main financial contribution made by the Airline Group to the Composite Solution has been by supporting the increase in NATS' charges to Airlines. Airline Group members represent some 27 per cent of NATS En Route's total income, and are expected to contribute at least £30 million of the increase in charges in the period 2003-2010, besides any contribution that may arise from the new volume flexibility. They have also accepted subordination of their equity stake in the business to the new investment by the Government and BAA plc.

Finding and accommodating a new investor was not easy

3.21 Given the position of the Airline Group, it was clear that to meet the Department's condition that it would only provide new shareholder funding on the basis of a matching private-sector investment, a new investor would have to be found. This was not initially welcomed by other participants. The banks and the Airline Group faced the prospect of having to make concessions to accommodate a new investor, who would be likely to demand advantageous terms at their expense. NATS initially questioned whether an appropriate new investor could be found and were concerned about the delay and uncertainty that a selection process could add to the negotiations. However, the Department, backed within NATS by their Partnership Directors, stood their ground and secured their participation in a process to identify a new investor.

3.22 The process considered a range of different investors, most of whom would have a strategic interest in NATS' business. It included other countries' air traffic control businesses, suppliers of ATC systems, airport operators and facilities managers. The process tested the appetite of some 20 potential investors; this number was narrowed down to nine, and then short listing identified two potential investors. The narrowing and short listing was relatively straightforward because few players were seriously interested by the opportunity. The selection process identified BAA plc as the most suitable investor. NATS and its shareholders felt that BAA had a good strategic alignment with NATS and that BAA plc's modest required return and shareholder rights requirements made it the most attractive additional equity partner.

3.23 The implementation of BAA's proposed investment had to identify and address any perceived conflicts of interest, for example, in theory, BAA might have an incentive to award preferential air traffic service contracts to NATS, or, BAA might influence NATS to favour BAA's airports in providing air traffic management. The former possibility was evaluated as having little substance, as there would be no net gain for BAA in awarding preferential contracts to a supplier in which it had only a minority stake. However, it was addressed by a supplement to the Shareholders' Strategic Partnership Agreement, where BAA agreed that it will absent itself from the relevant parts of shareholder meetings and have no vote at such meetings or matters affecting the airports business in the UK. The latter possibility was seen as adequately safeguarded against by the Civil Aviation Authority's role as airspace regulator, by the terms of NATS' licence and by general competition law. In addition, the following factors ensured that the investment did not require European competition clearance:

- BAA will be a minority shareholder in NATS, with an equity interest and voting rights of less than 5 per cent;
- BAA would acquire the right to appoint only two non-executive directors to the board of NATS, out of a possible 17;
- Although BAA's consent as shareholder will be required for a limited number of matters, these rights are designed to protect BAA's interests as a minority investor, and will not give BAA the ability to exercise decisive influence over NATS; and
- The UK Government and the Airline Group will continue to have joint control over NATS.

13 **Costs of transacting the Composite Solution for the NATS PPP**

The costs of transacting the Composite Solution were equivalent to between one third and a half of the costs of obtaining the original deal.

Key Players	Costs of transacting the refinancing	Costs of transacting the original PPP
NATS	£12.9m	Total costs to the Public Sector were £30m plus some £25 million of costs reported to us by shortlisted bidders.
HM Government	£3.6m	
BAA plc	£2m - £3m	
Civil Aviation Authority	£1m (repaid by NATS)	
The Airline Group	£0.2m	

NATS, the Department and their advisers worked "hard and smart" to assemble the deal

3.24 The new deal was very challenging to negotiate because of the number of parties involved. In particular the Groups involved were not homogeneous. Not all of the four banks were equally amenable to meeting the requirements of NATS and the Department, and similarly some of the seven members of the Airline Group had to be convinced of the need to support the solution, particularly through price rises. Though NATS and its advisers conducted the face-to-face negotiations, the Department and its advisers performed an active supporting role by drafting some of the necessary documentation for NATS, meeting representatives of the banks and the Airline Group and by sending out clear signals that the Government's contribution was conditional on others doing their part and stressing the possibility of administration.

3.25 NATS made good use of its advisers, in particular:

- Through its direct involvement in negotiations it had observed a need to replace its initial financial advisers, Schroder Salomon Smith Barney (SSSB) with new advisers, in October 2002; and
- The new advisers, UBS Warburg, were selected in competition and part of their fee was based on achieving a successful outcome for NATS. NATS and other participants told us that they consider UBS did a very good job.

3.26 The banks were in a strong negotiating position as a result of their rights over NATS' finances in the original PPP structure. Though many of the elements of the Composite Solution, such as concessions from the CAA, had reduced the risks to which the banks were exposed; following September 11th banks perceived aviation as a riskier industry and were resistant to making concessions. But some useful concessions were extracted:

- In order to retain access to its bank facilities NATS will have to meet less onerous financial covenants. In addition, the financial forecasts that the Company is required to provide will, in the event of a dispute, now be reviewed by an independent arbitrator rather than a bank nominee;
- Part of the new investment by BAA plc and the Government will rank equally for interest payments with bank debt in most circumstances; and
- Margins and fees are subject to the Company's credit rating in the financial markets, as opposed to being subject to a pre-defined upward ratchet. This resulted in a reduction in the margins and fees that were payable before syndication of the NATS loans to other institutions.

Total costs to all players were lower than the costs of advisers in transacting the original PPP

3.27 Exercises of the scale and complexity of the NATS Composite Solution cannot be transacted without substantial cost. The costs disclosed to us are broadly one third of the level of costs incurred in transacting the original PPP, **(Figure 13 above)**.

Glossary

Term	Meaning
(In) Administration	At the discretion of the Courts, NATS' regulated en route business (NATS' regulated business) could have been placed in administration if it were, or was likely to become, insolvent
Administrator	An administrator would have been appointed with a duty to carry on NATS' licensed business pending the transfer of the business as a going concern
Airline Group	Group of seven UK airlines that formed to become the private sector partner in the NATS Public Private Partnership
Air Proximity (or Airprox) incident	An incident reported by a pilot or controller in which standard minimum separation distances between aircraft have been breached. A risk-bearing airprox is one where the UK Air Proximity Board considers there was a potential risk of collision
BAA	BAA plc, owner of seven UK airports including Heathrow, Gatwick and Stansted
CAA	Civil Aviation Authority, the safety and economic regulator of NATS and national airspace regulator
Composite Solution	A solution devised by NATS, with contributions from the Banks, the Airline Group, UK Government, BAA plc and the CAA, designed to provide them with more robust finances
CSFB	Credit Suisse First Boston, the financial advisers to the Department for Transport
Due diligence	The process through which a party to a proposed transaction, such as a business acquisition, investigates in detail the risks associated with it
The Department	The Department for Transport. Name of the vendor Department. Formerly the Department of the Environment, Transport and the Regions (1997-2001) and Department of Transport, Local Government and the Regions (2001-2002)
En route	Aircraft flying in UK controlled airspace, other than aircraft taking off or landing
Eurocontrol	The European agency for the safety of air navigation, based in Brussels
Investment Grade Rating	Indicates a relatively low probability of default and high likelihood of timely repayment. Specifically, a rating of BBB- or above by Standard and Poor's, or Baa3 and above by Moody's Investor Services
NATS	National Air Traffic Services Ltd
NATS (Services) Ltd	The unregulated subsidiary of NATS which provides air traffic services to airports and consultancy services to customers worldwide.

Term	Meaning
PPP	Public Private Partnership between the Government and a private sector strategic partner
Senior debt	Debt that has first call on the cash of the borrowing business when due for repayment
SSSB	Schroder Salomon Smith Barney, initial financial advisers to NATS, having earlier been advisers to the Airline Group in their acquisition of the controlling stake in the PPP
Strategic Partnership Agreement	The agreement between the shareholders in NATS; the Department, the Airline Group and BAA plc
UBS Warburg (now UBS Limited)	Financial advisers to NATS from October 2002

Appendix 1 A summary of the previous National Audit Office Report on the NATS PPP

The public private partnership for NATS contains many positive elements. But the financial position of the Company will need strengthening to enable it to make further vital investment to expand the capacity of Air Traffic Control.

In its study of the PPP for NATS, the NAO found that the strengths of the PPP include provision for continuing high standards of safety and for national security, and also for accountability to Government and the public interest. There are also safeguards to prevent NATS discriminating in favour of its shareholders. And the taxpayer raised some £800 million from the sale of a 46 per cent stake in NATS to the Airline Group, a consortium of seven UK-based airlines.

But the high proceeds were partly achieved by increasing the level of NATS' bank debt. NATS' new financial structure, with increased indebtedness to banks and comparatively little equity from investors, makes the organisation vulnerable to downturns in traffic, such as that which followed September 11th. The Department and their advisers had decided, mainly on the basis of financial projections that assumed constant growth in NATS' traffic and income, that the financial structure of the PPP would be sufficiently robust to cope with short-term reductions in traffic levels. The downturn following September 11th, however, has been so severe that there is still a risk that NATS will not be able to fund and deliver its investment plan. Investment is essential to cope with future growth in air traffic, and thereby prevent increasing delays to flights.

It would have been impossible for the Department to have predicted the events of September 11th and the effects on air traffic. Nevertheless, there have been other significant downturns of traffic in the past 30 years, which were not modelled by the Department or its advisers when testing the proposed financial structure of NATS.

In its present form NATS is still vulnerable to further traffic downturns. Its prices are capped by its independent economic regulator, the Civil Aviation Authority. Because of the severe downturn in air traffic, NATS has been inhibited from using its long term loans by the terms of this borrowing, and its ability to invest is therefore severely restricted. NATS is now trying to bring an additional equity partner into the PPP, and if it is successful, it will be much better placed to survive future shocks and to drawdown on its long-term loans for investment. But strengthening the position of the company will require positive and complementary responses from many parties, including investors, banks and the independent economic regulator.

Source: Statement by the National Audit Office on the publication of the Report: The Public Private Partnership for National Air Traffic Services Ltd, 24th July 2002

Appendix 2 The National Audit Office's approach to the examination

Scope

As is our normal practice, we determined the scope of our examination using principles of Issue Analysis.

The **Situation** that existed was that: "The NATS PPP was established mainly to allow the company to grow its business free of the constraints of the public sector".

The **Complication** that made this situation worthy of study was that: "The financial structure proved to be insufficiently robust, and was difficult to remedy".

This led to the following **Key Question**: "Does NATS now have robust finances, to which all stakeholders have made equitable contributions?"

Main aspects of the National Audit Office's Methodology

In undertaking this examination we:

- Designed the examination using experience acquired on earlier studies of privatisations and Private Finance Initiative projects;
- Took into account matters raised in our previous report and in evidence provided to the Committee of Public Accounts by NATS and the Department for Transport before, during and after the Committee's hearing on 18 November 2002.
- Reviewed information from the Department's staff, advisers and records about their negotiations with other participants in the Refinancing process;
- Met with NATS, the Partnership Directors and the Airline Group to understand how the PPP structure has performed in the difficult circumstances since September 11th, and how negotiations for refinancing were conducted; and
- Met with senior regulatory officials of the Civil Aviation Authority and reviewed key decision documents on the reopening of NATS' charge controls.

Collection of information

We gathered relevant information from a number of sources including:

- an extensive examination of the Department's papers, documentation prepared by advisers, and submissions by other participants;
- interviews with the Department's relevant officials and advisers, on their strategy for the negotiations and their continued involvement in the process, including the selection of a new investor;
- A meeting with the responsible Project Director of BAA plc;
- Outputs from financial models and sensitivity analyses run by NATS at the request of their bankers and other stakeholders;
- Business plans and performance reports by NATS;
- monitoring of reports and commentary in specialist aviation industry websites and news "feeds", including public discussion boards used by NATS staff; and
- contacts with the Civil Aviation Authority's Safety and Economic regulators.

Appendix 3 Chronology of key events in the refinancing of the NATS PPP

Date	Event
2001	
26th July	PPP agreement completed between the Department and the Airline Group
9th August	Chris Gibson-Smith announced as new non-executive Chairman of NATS
11th September	Terrorists attack World Trade Center and the Pentagon
2002	
8th January	NATS announces its intention to apply for a review of the regulatory price formula to be applied to its en route business
4th February	NATS applies to the Civil Aviation Authority for an increase in price caps to compensate for decline in air traffic following Sept 11. Proposal is for real price increases of 4% in 2003, 3% in 2004 and 2% in 2005, worth some £200 million
March	NATS invites Outline Proposals for investment in NATS through the Airline Group. Government provides, along with the banks, a £60 million interim loan facility to NATS, pending agreement on the restructuring. The facility was not actually used
25th April	NATS announces a £1 billion investment plan
May	CAA issues a consultation document on NATS' application for an increase in prices
24th May	Deadline for Outline Proposals for investment in NATS
28th May	Shareholders and NATS select BAA as most favourable candidate investor
12th July	NATS formally requests additional shareholder investment from HM Government
13th September	NATS submits to CAA a 'Revised Composite Solution to the Post September 11 Difficulties'
16th September	HM Government confirms new investment of £65 million subject to identical investment by BAA plc
30th September	Interim loan facility closed
18th October	UBS Warburg announced as NATS' new lead financial advisers
October	CAA issues proposals for public consultation on reopening NATS' price cap
20th December	CAA announces modifications to NATS' price caps, for real price decreases of 2% in 2003, 2004 and 2005
2003	
18th March	CAA confirms new price caps, as a pre-condition to the investment in NATS by BAA plc (and reinvestment by the Government). CAA consults over a possible new flight delay penalty regime (confirmed in June)
19th March	NATS' new financial package approved by CAA and documentation completed
1st April	NATS launches 1st phase of £1 billion investment plan in the form of £127 million, 10-year programme for upgrading 20 radar sites
11th August	NATS (En Route) Plc issues £600 million 'guaranteed secured' bonds, replacing its bank-funded acquisition facility

Appendix 4 A summary of the position of the main participants in the Composite Solution for NATS

1 HM Government, through the Department for Transport		
What they wanted from the deal	**Achieved**	**Comments**
To restructure NATS so as to allow it to implement its business plan for enhancement of UK ATC. At extreme, to avoid NATS going into administration, or retreating into public ownership, with the attendant uncertainties and risks to the business	Yes	
Acting as a responsible shareholder, to negotiate a fair return from any further investment in NATS	Probably, subject to NATS' performance	Government's £65m investment ranks equally (both shares and loan notes) with BAA plc's investment, (See below)
To leave NATS still in the operational control of the private sector, and off government's balance sheet	Yes	
A contribution from each of the key parties	Yes	Though not necessarily equal or equitable contributions
To preserve the quantum of the Employees' Trust stake	Yes	Through a fairly modest top-up by the other shareholders
What the other parties wanted them to contribute to the deal [Which parties]	**Conceded**	**Comments**
Originally, to contribute a greater cash injection to NATS than was implied by their remaining shareholding	No	
To continue the £30 million interim loan facility to NATS, pending agreement on the restructuring [ALL]	Yes	As Banks. [Neither facility was actually used]
An additional investment of £65 million in NATS on equivalent terms to the new investor, BAA plc [ALL]	Yes	Increased from the £50m initially offered
Tolerating dilution of their pre-existing equity stake in NATS, which ranks behind the new loan stock investment from BAA and HMG [BAA plc]	Yes	
Tolerating dilution of their Board influence to the limited extent that the number of directors has increased to 15 from 13 to accommodate BAA plc [BAA and the Airline Group]	Yes	All three Partnership directors still retain their various vetoes and inspection rights. The Airline Group could outvote HMG before anyway
Bears own transaction costs (£3.6 million)	Yes	Mainly advisers' fees

2 The Controlling shareholder: The Airline Group		
What they wanted from the deal	**Achieved**	**Comments**
To avoid NATS going into administration or other drifting situations, raising attendant uncertainties and risks to airlines' flight operations in and out of UK airspace	Yes	The likely outcome of administration being reversion to public sector ownership, with loss of the assured investment programme, and less prospect of improved working practices
What they wanted from the deal (continued)	**Achieved**	**Comments**
To avoid part ownership of NATS by a new investor that would not share their "not for commercial return" ethos	Yes	
To maintain their operational control of NATS, [and enhance technical and operational skills on the board]	Yes	The Airline Group still has a majority on the NATS board
To avoid having to make a further investment in NATS to match the Government's, during a difficult climate for airlines	Yes	
To avoid the seven member airlines having impairment of the carrying value of their existing investments in NATS	Largely, Yes	Five of the seven airlines have not written down this investment
What the other parties wanted them to contribute to the deal [Which parties]	**Conceded**	**Comments**
Originally, to contribute a greater cash injection to NATS than was implied by their remaining shareholding	No	
To continue the £30 million interim loan facility to NATS, pending agreement on the restructuring [ALL]	Yes	As Banks. [Neither facility was actually used]
An additional investment of £65 million in NATS on equivalent terms to the new investor, BAA plc [ALL]	Yes	Increased from the £50m initially offered
Tolerating dilution of their pre-existing equity stake in NATS, which ranks behind the new loan stock investment from BAA and HMG [BAA plc]	Yes	
Tolerating dilution of their Board influence to the limited extent that the number of directors has increased to 15 from 13 to accommodate BAA plc [BAA and the Airline Group]	Yes	All three Partnership directors still retain their various vetoes and inspection rights. The Airline Group could outvote HMG before anyway
Bears own transaction costs (£3.6 million)	Yes	Mainly advisers fees

3 The new investor: BAA plc.

What they wanted from the deal	Achieved	Comments
To secure the benefits of the PPP in terms of a stable and enhanced Air Traffic Control service. To avoid the worst case of NATS going into administration, with the attendant uncertainties and strategic risks to their own UK airports business	Yes	As HMG
To obtain a relatively certain (although modest) rate of return on most of their investment in NATS	Yes	As HMG
To obtain some future flexibility to dispose of part of their investment without loss of rights (e.g. vetoes)	Unclear	
To obtain an appropriate level of representation on NATS' Board in return for their investment	Yes	Two Directors
What the other parties wanted them to contribute to the deal [Which parties]	**Conceded**	**Comments**
An investment of £5 million in pure equity and £60 million in loan notes, on terms that were competitive in market terms [All others]	Yes	As HMG
Accepting constraints over their rights to intervene in NATS, including the voting rights of their two non-executive directors over BAA-related matters. [HMG and the Airline Group]	Yes	To address the potential risks of direct influence over the main supplier of ATC at their airports
What the other parties wanted them to contribute to the deal [Which parties] (continued)	**Conceded**	**Comments**
Bears own transaction costs (total £2-3 million) [All others]	Partly	Mainly advisers fees, not reimbursed above a £1 million threshold
To justify their investment through their own due diligence, rather than reliance on warranties and assurances from NATS or other parties [All others]	Partly	

4 NATS Management		
What they wanted from the deal	**Achieved**	**Comments**
To avoid the company going into administration or other sub-optimal situations which would cause uncertainties and risks to the business and its customers	Yes	Other sub-optimal situations included "do-minimum" programmes
To avoid having to divest assets in a way that would damage the future viability of the company	Yes	In particular, NATS Services Ltd
To free NATS management to run the business without being subjected to the full range of project finance-type constraints imposed by lender banks within the original PPP facilities agreements	Within reasonable limits, Yes	
To enable the Company to commence procurement within its 10 year investment programme	Yes	Initial contracts have been signed for Radars and software
To ensure that NATS' finances should be sufficiently robust to withstand future downturns in traffic	Yes	Though the Company is still exposed to some traffic risk from the severest scenarios
What the other parties wanted them to contribute to the deal [Which parties]	**Conceded**	**Comments**
Cost cuts estimated at some £170 million over CP1 [ALL]	Yes	Down from £200m, (pay settlement)
Agreement to a tighter performance regime, which will penalise them more heavily for causing delays to flights [CAA]	Yes	Ceiling doubled to £10m
Agreement to more exacting financial reporting to the CAA, and restrictions on NATS' freedom to change financial arrangements without referral to CAA [CAA]	Yes	Listed in revised licence requirements
Bears own transaction costs [All parties]	Yes	Mainly advisers fees
5 The Civil Aviation Authority, representing users' interests		
What they wanted from the deal	**Achieved**	**Comments**
To avoid NATS going into administration, with the attendant uncertainties and risks to the business	Yes	
To ensure that Users made only a proportionate contribution through higher prices, as part of a wider financial solution	Arguably Yes	Also coupled with strengthening of the performance regime
To ensure that NATS' finances should be sufficiently robust to withstand future downturns in traffic	Arguably Yes	
To free NATS management to run the business without being subjected to the full range of project finance-type constraints imposed by lender banks	Within reasonable limits, Yes	The Banks take the view that NATS' managers were already free to run the business
What the other parties wanted them to contribute to the deal [Which parties] (continued)	**Conceded**	**Comments**
Price increases worth some £100 million to NATS over the first two control periods up to 2010 [ALL PARTIES, apart from a minority of Airlines]	Yes	The CAA had earlier rejected a request from NATS for much larger increases
A "volume flex" which ensures that NATS no longer bears the full risk of downturns in traffic, because its prices will adjust automatically in response [ALL]	Yes	The flex is in some respects more generous than originally requested but currently runs to 2005 only
Bears own transaction costs (£1 million)	No	NATS paid their advisers' fees of £1 million

6 The four lead Banks lending to NATS

What they wanted from the deal	Achieved	Comments
To avoid NATS going into administration, with the attendant uncertainties and risks to their loans	Yes	
To ensure the terms of their loans remained such that they could still syndicate them to other banks in the future, reducing their exposure	Yes	As part of this, ensuring NATS gets a "strong" investment rating
To avoid having to convert any of their debt to an equity stake in NATS	Yes	
What the other parties wanted them to contribute to the deal [Which parties]	**Conceded**	**Comments**
To continue a £30m interim loan facility pending agreement [ALL]	Yes	As HMG [Neither facility was actually used]
Agreement that interest payments on the new investment in NATS' regulated business from HMG and BAA plc would have equal status with bank debt [HMG and BAA]	Largely	Interest payable to HMG and BAA plc
To reinstate NATS' access to the capital investment facilities put in place in the PPP [ALL]	Yes	But a much smaller facility than before, at NATS' request
To relax the terms of their loans so that the banks cannot bar NATS' access to facilities as easily as before [ALL]	Yes	Future operation of forward cover ratios
To contribute to new cash buffers that NATS can access without bank restrictions [ALL other parties, but particularly NATS and CAA]	In part	New buffers are established. Banks provided a new Standby facility
To reduce their interest rate margins and arrangement fees, expenses and other costs [ALL]	No	They largely maintained their fees and margins, in return for their agreement to the buffers. The deal worked without concessions on this

Reports by the Comptroller and Auditor General, Session 2003-2004

The Comptroller and Auditor General has to date, in Session 2003-2004, presented to the House of Commons the following reports under Section 9 of the National Audit Act, 1983:

		Publication date
Cross-government		
Managing resources to deliver better public services - Report	HC 61-I	12 December 2003
- Case studies	HC 61-II	12 December 2003
Defence		
Operation TELIC - United Kingdom Military Operations in Iraq	HC 60	11 December 2003
Public Private Partnership		
Refinancing the Public Private Partnership for National Air Traffic Services	HC 157	7 January 2004

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