

Considerations on Licence Maturity

7th July 2011

Background

The current licence notice period for NATS is ten years with the earliest date for submission of such notice not permissible prior to 2021, making 2031 the earliest end date, which is 20 years from today. This is a shorter licence notice period than the majority of other UK regulated utilities that have the same principles of regulation, particularly where there is a concept of a Regulated Asset Base (“RAB”), and it is unique amongst the companies where the regulated income stream comprises the majority of the group earnings.

Risks to NATS

- Reduces the ability of NATS to secure optimal long-term funding with the following implications
 - Increases the cost of debt capital given shorter maturities
 - The spread of Gilt yields between 10 year and 30 year maturities varies considerably, from one being 1% higher to being 1% lower or more over the years, even prior to considering the relative attractions on credit pricing shown to utilities by fixed income investors. Although the current shape of the yield curve implies higher cost of debt for longer term maturities, this is likely to revert back to the recent norm for the UK rate market of a downward sloping yield curve for maturities over 10 years
 - Need to refinance more frequently introduces additional costs - bond issuance fees and/or bank arrangement and commitment fees
 - Increased execution risk in the capital markets from multiple refinancing events
 - Raises execution risks surrounding a long-term investment plan for the business without being able to access long-term debt financing, potentially influencing decisions on timing and scale of capital expenditure within the core business. Feedback from the company directly has pointed to several service critical assets which have a lifespan of 20-40 years, such as the replacement flight data processing system, the electronic data display update system, the radio & distance measuring equipment as well as the new Prestwick centre, for which matched life funding would be optimal.

Evidence in Other UK Regulated Companies

- At privatisation in 1989/1990 the Regional Electricity Companies (“RECs”) and the Water and Sewerage Companies (“WASCs”) had a minimum guaranteed 35 year licence period. There was an important distinction between water and electricity at the time – the water utilities had a 10 year notice period not to be issued within 25 years, while the electric utilities had a 25 year notice period not to be issued within 10 years. The electric and, subsequently, the gas utilities retain the 25 year rolling notice period. Whereas the WASCs have had their notice periods amended by the regulator, OFWAT, as discussed later. Upon sale of the gas distribution networks in 2005 by National Grid, the rolling licence term period was set at 25 years, matching the RECs.
- Currently, both BT Group and Network Rail have licences with only 10 year notice periods and yet both groups have accessed the debt markets for much longer maturities. There are special circumstances to both:
 - Firstly, Network Rail funds via a special purpose bankruptcy remote funding vehicle which benefits from a Financial Indemnity from the Department for Transport, which means the licensed entity, Network Rail Infrastructure Limited, is not directly supporting the funding. In essence investors are looking to the credit of the Government without being concerned about the licence or operating performance of the underlying business;
 - In the case of BT Group the licensed entity, BT Openreach, comprises considerably less than half the cashflows of the whole group. This makes both equity and fixed income investors more sanguine about the licence terms in the context of the broader trends in the fixed line networks for communications companies. In particular the value of the underlying assets extends well beyond a ten year timeframe, providing additional comfort on re-sale value or leasing options in the event of loss of licence.
- It has become generally accepted in the debt markets that even in the instance where water, gas or electricity companies were to lose the operating licence, they retain ownership of the underlying assets. The sale or leasing of such assets is likely to be more than enough to cover the residual debt obligations. The same logic cannot be applied to NATS, where many assets have considerably shorter expected lifespans, perhaps as short as 5-10 years, and where the risk of obsolescence is considerably higher.
- In 2002, WaSC licences were amended to match the 25 year rolling licence period that existed for electricity and gas companies (see Appendix)

- OFWAT announced that this change was made in order to reassure investors and to ensure that companies in the industry were able to raise the finance required to raise their current and future capital investment programmes

BofA Merrill Lynch Conclusion

- NATS won't be able to fund efficiently beyond 2031. As the 2026 bond amortises from 2012 onwards this will place increasing pressure on the company to roll over shorter-dated financing.
- While water, electricity and gas precedents illustrate that it is possible for regulated utilities to secure long term funding at reasonable rates, even beyond their licence periods due to the longevity of the underlying assets, this is not entirely the case for NATS. NATS requires the support of a longer-term licence period in order to facilitate access to the longer-dated funding and with the benefit of pricing for such debt which is more in line with a utility peer group, rather than a transport or airline peer group.
 - Longer-term funding is highly beneficial to corporate borrowers in the sterling market; all other UK RAB-based utility borrowers in the UK market have minimum licence notice periods of 25 years (with the exception of those mentioned, BT and Network Rail, which are not pure utilities for credit investors).
 - A longer licence period allows the company, the management and the regulator to plan on the basis of an investment cycle, including quite long commissioning periods of 5 years or longer, with the benefit of access to lower cost and longer-dated debt capital.
 - A longer licence notification period would provide NATS with the ability to match funding for its longer-dated assets such as the new Prestwick centre, as well as other systems and operating equipment such as the radars, with equally long-dated liabilities.

Appendix: Evidence From UK Regulated Comparators

		Net Debt / RAB ⁽¹⁾	Regulatory depreciation	Longest Maturity Date	Licence Terms / Notice
Water Companies		• 73%	• 20-30 years ⁽²⁾	• 2053	<ul style="list-style-type: none"> • At IPO: <ul style="list-style-type: none"> - Term: 25 years - Notice Period: 10 years • Currently <ul style="list-style-type: none"> - Notice Period: 25 years • "We recently announced proposals to increase the notice period to 25 years. We agree with respondents that extending the notice period is likely to reassure investors and ensure that companies are able to raise the finance required to deliver their current and future capital investment programmes." - Ofwat, 2002
		• 74%	• 20-30 years ⁽²⁾	• 2057	
		• 59%	• 20-30 years ⁽²⁾	• 2067	
		• 62%	• 20-30 years ⁽²⁾	• 2057	
Electricity Distribution		• 55%	• 20 years	• 2035	<ul style="list-style-type: none"> • At IPO: <ul style="list-style-type: none"> - Notice Period: 25 years - Licence not to be served earlier than 2000 as at 1990 • Currently <ul style="list-style-type: none"> - Notice Period: 25 years
		• n.a. ⁽³⁾	• 20 years	• n.a.	
		• 65%	• 20 years	• 2032	
		• n.a. ⁽³⁾	• 20 years	• 2041	
		• n.a. ⁽³⁾	• 20 years	• 2056	
		• 51%	• 20 years	• 2046	
		• 63%	• 20 years	• 2056	
Gas Distribution		• 70%	• 45 years	• 2058	<ul style="list-style-type: none"> • Currently: <ul style="list-style-type: none"> - Notice period: 25 years
		• 75%	• 45 years	• 2036	
		• 70%	• 45 years	• 2040	
		• 72%	• 45 years	• 2043	
Telco Network		• n.a.	• n.a.	• 2037	<ul style="list-style-type: none"> • Currently: <ul style="list-style-type: none"> - Notice period: 10 years
Rail Network		• n.a.	• n.a.	• 2052	<ul style="list-style-type: none"> • Currently: <ul style="list-style-type: none"> - Notice period: 10 years - First notice date no earlier 2019
NATS		• 55%	• 12-15 years ⁽⁴⁾	• 2026	<ul style="list-style-type: none"> • Currently: <ul style="list-style-type: none"> - Notice period: 10 years - Earliest notice period is 2021

Source: Bloomberg, Factset, Company data

(1) Holding company debt included

(2) Based on inflation indexed asset register

(3) Integrated utilities with intercompany debt and opco level

(4) Depending on regulatory period