# POSITION PAPER ON AMENDMENT TO NATS (En Route) plc ("NERL") LICENCE TERM

## Background

1. The NERL Licence was granted in accordance with the Transport Act 2000. Its provisions are divided into "terms" (which cannot generally be amended) and "conditions" (which can be amended, generally by the CAA). The DfT and the CAA have a duty set out in the Transport Act that includes promoting the efficiency and economy of NERL and securing that NERL will not find it unduly difficult to finance its Licence activities.

2. This paper sets out the position of NERL on the term of the Licence.

## Current licence term

3. Paragraphs 6 and 7 of the Licence grant NERL the right to provide UK and Oceanic ATC services until expiry of a notice served in accordance with the Licence. Notice cannot be served before the twentieth anniversary of the grant of the Licence and must last a minimum of 10 years, i.e. the earliest date on which notice can be given is 28 March 2021 and the earliest date on which notice can expire is 28 March 2031.

## NERL's principal concerns regarding current licence term

### a) Reduced efficiency and certainty of financing

4. NERL's core Licence obligations are to deliver the range, availability, continuity, cost and quality of air traffic services thereby maintaining a critical part of the UK's national transport infrastructure. NERL is only able to discharge these obligations if it undertakes long term R&D and investment programmes. Many of the assets associated with these programmes are long lived with average asset lives of around 15 years after commissioning, which in itself can take up to 5 years. Under the economic regulatory regime, NERL recoups the cost of these investments, with a return to cover the financing, over regulatory depreciation periods which are currently limited to a maximum of 15 years.

5. While the average life of equipment is 15 years many of NERL's existing assets are around 25 years old. Examples include the current radars, DVORs and DMEs (distance measuring equipment) and the current flight data processing system (NAS) which has been in service for 36 years. While new systems may not have such a long life it is currently envisaged

that the replacement flight data processing system will be in place for 20 years as will the new voice communication system installed in 2006 and the DVOR replacement[1]. EDDUS (the electronic data display update system) that went live in 1993 will be in service until 2018 (i.e. 25 years). Further, the new Prestwick centre, which opened in January 2010, is expected to be on NERL's asset register for 40 years.

6. NERL's strategy to date has been to match these requirements for long term assets with long term financing. This provides certainty of funding and lowers the financing risk of NERL's investment programmes.

7. Without the ability to issue long term debt, NERL would be constrained in making economic and efficient long term decisions for its R&D and investment programmes.

8. At the time of the Composite Solution in 2003, NERL secured long term funding of £600m at an interest rate of 5.25%. The borrowing term of 23 years, which includes progressive amortisation of principal including £86m in CP3, extends to 2026. This is five years before 2031 which is the potential earliest Licence termination date.

9. As time progresses and the 20 year 'fixed' period of NERL's Licence runs its course, the company is only able to guarantee to its lenders a maximum of 10 years of operational revenues, since 10 years' notice of termination can be given at any time after that 'fixed' period expires. Market practice for long term debt such as bonds is for creditors to be granted the ability to protect themselves against the risk of non-repayment of debt principal and interest as soon as notice of termination is given. This protection can take various forms:

   i. relatively benign forms such as a regime that would ensure the company would set aside an element of profit over the 10 year period to ensure it would be able to discharge its obligations (to the extent NERL could not otherwise discharge them at the end of the Licence period; eg from the proceeds of sale of the relevant assets to a successor licensee) – potentially constraining dividend payments;

   ii. more aggressive forms such as a demand for immediate repayment of principal upon the service of notice (or perhaps requiring collateral which would be costly to set aside).

[1] Upgrades may occur during a project's lifecycle.

10. Depending on the approach provided for, the financial position of the company and the attitude of lenders at the time, funding of these requirements may necessitate increasing prices to customers to cover NERL's increased cost of capital and a negotiation of new borrowing facilities on more onerous terms. The option in 9.ii. above creates for the company a requirement for immediate short to medium term refinancing with associated risk.

11. It is also reasonable to assume that decreasing predictability in NERL's Licence retention and associated uncertainty may also have an adverse credit rating impact with the higher cost that this will bring. Moreover, NERL may find itself constrained to issuing 10 year bonds (possibly with some amortisation) going forward on a rolling basis.

12. A longer notice period would also enable NATS to compete for funds at the long end of the market. This would mitigate risks inherent in shorter dated maturities such as event risk or the risk of disruption in the debt markets that affect both the availability and cost of future financing. It would also avoid the significant costs and fees that would result from the need to frequently refinance shorter term debt.

13. Additionally, there are periods when market conditions make it more cost effective to issue longer term debt, further enabling NERL to reduce its borrowing costs and hence its cost of capital.

**b) Economic regulatory considerations**

14. In addition to the considerations above, the CAA will want to ensure that it does not become unduly difficult for NERL to finance activities authorised by its licence. This includes ensuring that NERL remains solvent and that any proposals for the protection of bondholders' repayments do not put at risk NERL's solvency, access to NERL's en route assets or might potentially prejudice NERL's ability to perform its licence obligations or the smooth transfer of the licence from NERL to another party.

15. The potential for the notice period to give rise to issues was recognised as early as 2003 when CAA included a high level statement of regulatory policy in its decision on the reopening of NERL's price cap. That statement recognised in principle that NERL would not be able to raise necessary funding unless the position of investment straddling the notice period was adequately addressed (bearing in mind the potential that assets might transfer to a successor licensee).

16. It should be noted that in 2007 NERL sought to put in place new bonds. In the event, the transaction was put on hold as a result of the instability that subsequently arose in the financial markets. At the time, the potential ‘overrun’ past the earliest termination date of 2031 would have been c.6 years for a 30 year bond. The approach contemplated to deal with this issue was to provide for the possibility of an agreed regime with provision for some automatic consequences (such as a dividend block and potential "trigger event") if such a regime could not be agreed in practice. This exercise proved to be complex and highlighted the challenges in pursuing this route.

17. NERL management still has a requirement for the optimal amount of long term bond financing when the market pricing is acceptable. However, as time passes, the potential ‘overrun’ period grows longer. With the requirement to refinance the amortisation of NERL’s £600m bond which commences in March 2012, NERL needs to tackle the licence term issue now or will be restricted to utilising shorter term facility options which may come at a higher all-in-cost.

**c) Comparison with peer group and other regulated companies**

18. Under the current licence term, NERL will be at a comparative disadvantage to its peer group of national en route air traffic service providers. Comparable ATS providers (and in particular NERL's European peers) do not face the possibility that their operational authorisation might be removed on a period of notice that is shorter than their typical investment/financing cycle. This creates a systemic and inappropriate inefficiency and so puts NERL at a disadvantage when discussing collaboration or potential future developments with its peers.

19. Other economically regulated utilities (e.g. water companies) have had the minimum notice period in their licences increased from 10 to 25 years reflecting representations that this would “assist companies’ long-term planning, deliver a lower cost of capital and better reflect the lives of the assets of the industry". NERL’s proposals would bring it into line with other utilities putting NERL’s ability to raise cost effective finance on the same footing and allowing it to compete for long-dated and possibly cheaper funding.

**Options for amendment**

20. There are two options for amending the licence. The ‘fixed’ period could be extended, perhaps back to 20 years. Alternatively, the minimum notice

period for termination could be extended, perhaps to 25 or 30 years instead of 10.

21. Both of these options would address these issues in the short run. However the company believes that resetting the ‘fixed’ period would only be a short term fix and would only defer issues which will inevitably re-emerge in the future.

22. The alternative approach is more attractive for the following reasons:

    i. Permanent fix – no future requirement to extend the ‘fixed’ Licence period.

    ii. Matches investment cycles more closely to tenure – there is a logical symmetry between the resulting minimum length of the Licence and the long term nature of investment required by way of the Long Term Investment Plan.

    iii. Provides security for equity – the clear repayment profile for creditors reduces uncertainty for current and potential equity investors, both in terms of the ability to refinance and the residual value of their equity investment.

**In summary**

23. The view of the company is that an extension of the term of the Licence is a necessity for NERL to continue to obtain cost effective long term financing on terms that would not impede NERL’s ability to invest in the long term infrastructure investments required to support its Licence obligations and ensure that it can deliver its services efficiently to its customers.

24. NERL believes that the best way of achieving these outcomes is to extend the minimum term of the notice period under the Licence to a period of 25 to 30 years.