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**'PUBLIC INTEREST COMPANIES'
AND
RISK**

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Introduction

In this paper I will look first at the basic interrelationships between business risk and corporate capital structures, then at the risks which arise naturally from the process of creating new “Public Interest Companies” (PICs), and, then recount the NATS experience and draw some conclusions from it.

Companies and their health, that is their ability to generate benefit for shareholders and stakeholders, are the heart of our economy. It is in the public interest that they succeed.

The management of risk is the sine qua non of business and is the central focus of this paper. Good management aims to be able to recognise risk in all its forms and have the ability to deal with it. That ability is founded on the protocols, processes, standards, knowledge and quality of a company’s systems, its people and its leadership. A company’s capital structure, its balance of equity and debt, is a central tool in the mitigation of risk.

I took on the Chairmanship of National Air Traffic Services (NATS) on September 1st last year. NATS is an enterprise vital to the public interest and one which brings together, to an unusual degree, all the aspects of the title you have given me. September 11th then added an intensity of risk which was unforeseen and unprecedented, and consequently a unique intensification of the challenges we already faced. Some of these I would like to share with you.

New, “Public Interest Companies”, and NATS is a clear example, are in any case particularly vulnerable to business risk. The existing employees have little experience in the more complex world they now face; they are themselves uncertain and face increased personal risk, and even the simplest PICs are engaged in complex changes for which they have little or no preparation.

It follows that an acute understanding of the true risks faced by a new PIC is essential for its owners, lenders and management. It is also essential that these risks were fully understood at the time of the PICs creation, and that the structures put in place have the flexibility to respond as the risks are revealed.

The financial structure I inherited with NATS did not foresee, or allow for, the impact of September 11th. However, NATS is still here. It follows, and it has been my experience, that the original structure of NATS had inherent resilience. However, what has been used up in dealing with the consequences of September 11th has been much of the reserve of flexibility in the company. Thus - and I will come to this later – the role of equity in the mitigation of future risk is still on the table. Nevertheless NATS from its creation has proved more robust



and better equipped to deal with risk than many had thought, or still think. As Chairman, it is this robustness of the Company and its shareholders, lenders, and people, which has enabled me to chart a course through very choppy waters.

Business Risk and Corporate Capital Structures

Centuries of commercial practice have established that the owners of an enterprise bear the residual risks. They also retain the residual value after all other claims have been settled. Financial markets not only provide capital but have, of course, learnt to price this capital according to risk. The principles involved in these statements have become deeply encoded, and the result is a complex inter-relationship between owners, lenders, money and risk, but, in its standard form, it is a relationship that reflects hard won experience. It is wise to treat these basic learnings and agreements with the respect they deserve.

We must, therefore, be concerned with the balance of responsibility between owners and lenders when we form a new PIC. Low debt structures are unambiguous on this subject and give the company, but not the owners necessarily, an inherent resilience to risk. However, it is in the extreme that uncertainties can arise. Therefore, all-debt, or largely all-debt, structures should imply one of two things. Either, there are no, or few risks, or, the owners have offered collateral or guarantees which the lenders are confident will be honoured if needed. Under these conditions an all-debt structure can be a viable proposition and its actual robustness will be a function of the cash to debt service cover ratios. In the absence of clarity on risks or collateral, it is clear that the lenders should either not lend or they should increase the cost of their loans.

At this point we meet a dilemma. Lenders expect their principal to be repaid as a priority, but owners have agreed to forfeit that right and accept that their capital bears the ultimate risk. There is thus, always, a critical difference between the risks a lender is prepared to face and those that an owner faces. The dilemma in an all-debt structure, where the owners have exposed little or no capital, is that the lenders come to bear the owners risks unless the collateral is totally secure.

This is an important point and one which, as a director of Lloyds TSB, I well understand. Of course, while it only becomes an issue when things go wrong, it is surprising how often they do, and I believe it is important the point is better understood in future PICs. Both Railtrack and NATS demonstrate that lenders have essentially no appetite for becoming owners. They are highly, even viscerally, averse to assuming the associated exposures. The days when banks were willing to accept sovereign risk have long gone!



In summary, a lender who puts money into an all-debt structure must have confidence in either their understanding of the risks they face, or in the collateral offered by the owners. When neither condition is true, then the price of loans should rise to reflect the exposure. It's no accident Argentinean bonds were yielding 14.5% twelve months ago.

So, how well have the risks been understood in recent PIC initiatives? Where high debt structures have been used, is it true that there were few risks or the collateral was AAA rated?

RISKS ARISING NATURALLY FROM THE PIC PROCESS

The act of bringing a company from public to private ownership involves profound change. The act of change itself is widely understood to be one of the most complex and risk laden of events. It requires exceptional skill to bring each of literally thousands of such changes to pass without triggering unmanageable risk. In a PIC, the changes are broadly being undertaken by people with limited experience in such things, and this inevitably increases the risk which the company's leadership must manage. Under these conditions, the new company is then simultaneously faced with a wide array of new, external and contextual risks.

The first and most important question asks whether the new "PIC" is inherently suitable for "liberation" from state finances. In other words, will the new company have sufficient customer sourced revenues to cover both its operating costs and all its future investment requirements? Will it generate sufficient free cash to properly cover its financing charges? This question, utterly self-evident in normal businesses, has to be answered in the context of a legacy of decades of State funding where significant capital renewal is probably essential. It has to be answered by new owners who have only the broadest of access and understanding, and it has to be answered within a planning context where major national infrastructure decisions can take decades to mature.

This simplest of questions can, therefore, only be dealt with within unusually uncertain boundaries. If the answer is yes, as in NATS' case, this allows the creation of standard commercial structures whose inherent risks should be reasonably well understood. If the answer is no, as in Railtrack's case, the resulting structure must be a hybrid of public and private commercial structures with all the added complexities and uncertainties such structures bring.

The PICs are being promoted as broadly "not for profit". This has a number of consequences. Firstly, the number of interested investors will inevitably be small. Secondly, an investor with shareholders and the financial markets to

satisfy will not expose significant capital to a “not for profit” situation. The capital must therefore be supplied by the lenders and hence we have to create high debt financial structures for these companies. In addition, those companies that are interested will tend to have strong strategic reasons for doing so. Whilst this creates strong alignment with the PIC’s goals it also tends to create a further concentration of risk.

By contrast, the owners of companies financed through the equity markets are highly diversified, and expect an economic return commensurate with the risks they face. They are therefore better able to accommodate such exposures and represent a much larger source of potential capital.

Now regulation: How do regulatory systems affect risk and its management? Of course all companies operate within some kind of regulatory framework and necessarily so. I was 30 years at BP and saw environmental and safety regulations increase dramatically and worldwide during that period and we co-operated with that process. But economic regulation is a rather different matter. The fact is such regulatory systems, which are but an approximation of the basic forces of competitive capital markets, are inherently risky for companies. Certainly far more risky than is generally understood.

In effect, they impose average conditions on individual companies which virtually never experience average circumstances. Market-based companies adjust their prices, plans, and costs in constant real time responses to real world changes which occur, literally, daily. This is quite unlike the 5-year, fixed-price, RPI -x contracts imposed by regulators. By definition these are inflexible.

One result of this process in the UK has been to drive companies to being average performers of medium to small size. Such companies are intrinsically at risk of both failure and take over. In essence, while the UK regulatory system has tended to concentrate on monopoly and competition issues, it has simultaneously ensured that the regulated companies are unable to compete with their international counterparts or flourish under adverse circumstances.

Before leaving the external risks which arise naturally from the PIC process and turning to the internal risks inherent in PIC status let me just make one seemingly obvious but nonetheless unavoidable point. PIC’s are caught up in the wake of economic change – recession, boom and the impact of disasters like September 11th. However PIC’s - companies in transition from 100% government ownership to mixed ownership carry the habit of Government dependence. They thus view the impact of external economic change and crisis from that perspective and therein lies risk.

INTERNAL COMPANY RISKS

The new management team of the company is itself at risk. Established managers from the pre-existing company find themselves undertaking challenges for which they have no previous experience. Simultaneously, new managers from outside are exposed by their lack of knowledge of, and familiarity with, the existing company. It follows that a synthesis of old and new is likely to create the best team able to deal with challenge, change and risk management. Nevertheless, unquestionably, there will be increased risk to be faced as a result of these changes; at least until the team establishes itself.

After people, technology. Those PICs with major infrastructure upgrade tasks face significant technology risk. These risks will manifest themselves as cost and timing uncertainties, and in the extreme cases there will be outright failure. The new air traffic management system at Swanwick was primarily delayed because the USA's Federal Aviation Authority, which was pioneering the original system's development, abandoned the programme when their own costs and delays spiralled out of control – in practice NATS took up and made work technological change that had defeated the Americans, but in doing so the original cost and time budget were significantly exceeded.

An additional source of risk is the incompatibility of legacy systems and modern technology. London Underground upgrades will have to be bespoke because the Victorian tunnel systems are incompatible with alternative modern rolling stock. Highly efficient, modern underground systems with proven capabilities, and hence low and defined risks, cannot be purchased from the USA or continental Europe because of this. The data processing system, which I've already described and which lies at the heart of NATS, will be incompatible with future products and will require customised interfaces which will be complex and unique. London airspace is the most complex in the world, many elements of the next generation of controlling technology will have to be specifically designed to meet the challenges London sets. In this case, the required technologies do not yet exist and their development will have to bear all the associated risks.

Project risk is allied to, but separate from, technology risk and rises from the sheer complexity of implementing many modern projects. In a company as technologically competent as BP our major project funding approvals allowed a 25% cost latitude on new projects, even though they may have been years in planning and were undertaken by engineers with long track records of successful delivery. With the exception of the UK road system, UK PICs with infrastructure upgrade tasks have limited experience to support them.

Under these conditions it would be unexceptional to allow for the possibility of 50% cost overruns arising out of a combination of project and technology risks. This is precisely the experience of new air traffic management systems in Germany and the USA, as well as the UK. Of course at NATS our determination is to do better than this, but it is quite unrealistic not to acknowledge and to allow for the uncertainties.

As stated earlier, the task of the new management of a recently formed PIC is to introduce change: to reduce costs, staff numbers, complexity, locations, committees, and meetings; and to improve processes, protocols, training, recruiting, reliability, revenues and perhaps profits. In the early days, both the old and the new management will have extensive uncertainties and lack knowledge. Similarly, all staff find themselves at risk, or facing significant increases in uncertainty, at the same time as being asked to undertake major changes. These changes may be at odds with their entire work experience and usually require rapid adaption and learning to pick up new skills

It is for all these reasons that change brings risk. Risk of not meeting targets, risk of industrial unrest, risk of systems failure, risk of drops in productivity.

The reality of risk flows deeply throughout private commercial enterprises and therefore a thorough understanding of risk must be a central issue in the formation of new Public Interest Companies.

NATS' Response to September 11th 2001

First, let me briefly summarise the broad challenges faced by NATS as a new PIC, and then use our responses to the September 11th terrorist attacks to illustrate risk management in real time. NATS has three main goals: to further improve our already high safety standards, to increase traffic handling capacity by a further 50%, and to reduce delays by 40%. We are required to raise our own capital from the financial market and our board and governance structures are modelled on those of a normal plc. Also, the Government made it clear that we should resolve our problems as an independent company would resolve them.

I retired from my post as a Group Managing Director of BP in the summer of last year, and as I have said, became Chairman of NATS on September 1st. Eleven days later the world changed! From that point my task was to use all NATS' resources and resilience to steer a course for survival and success, despite the unprecedented risks that had been revealed. The fact is that by the end of September we had understood the basic steps we would have to take to



restructure the new company. There were six key stages, all building on the inherent resilience delivered to NATS by its owners, its board and its lenders. At this point, I would like to acknowledge the key role played by NATS' CEO, Richard Everitt.

NATS faced an immediate 15% decline in its revenues and cash flows as a result of September 11th. Strict cash management and accelerated reduction in costs was therefore a standard, but essential, first step in stabilising the Company. This became a crash course in cash management and created new demands to which every team has responded. The result has been that NATS has not only survived without drawing on its interim loan facilities, but has also identified a further £200 million of savings to be delivered over the remainder of this first five year regulatory period. The second key step was to arrange the interim loan facility of £60 million with HMG and NATS' bankers. This safeguarded the Company's solvency position until longer term measures were put in place.

The third key step was to redesign the ten year investment plan in order to create a better alignment of the new cash situation and NATS' capital demands. This new plan required the approval of the CAA and this was achieved in March 2002.

The fourth key step was to bring additional capital into the business through a combination of new and existing shareholders investments. Although NATS' original capital structure had been designed to withstand shocks of the magnitude of the Gulf War it was not robust to the much greater impact of September 11th and recapitalisation has been a necessary part of our response.

However, the role of the new financial structure will be different from that of the original. Surviving the shock of September 11th has used up much of NATS' response capability in the event of future shocks or risks. There are unlikely to be further significant costs to extract, nor can the capital plan be radically rearranged again. So risk resilience must be introduced in new ways and an improved balance sheet is one, important step to achieving this.

The fifth key step was to agree with the lenders a new set of covenants and terms for the central loans which underpin NATS. Clearly the world the bankers now faced included greater risks than had been originally contemplated, and the original terms had not foreseen price changes so early in NATS' life. It became essential to redesign aspects of the loan structure to reflect the new reality.

The sixth and final key step was the application to the CAA asking for a change in the price control mechanism. This is the formula whereby charges to our customers are decided. NATS' original submission, in February this year, requested an increase equivalent to the entire amount required to repair the damage from September 11th. The CAA rejected the application, but for our part

we had laid down a marker defining the magnitude of the task. Steps 1 – 5 represent the actions taken since then by the Company, its owners and lenders to rebalance the finances. Customers are now being asked to accept some increase in prices, but increases which will still decline in real terms. This will be a unique achievement within European air traffic management systems.

One major final risk remains to be dealt with – that of another terrorist shock. We are in discussions with the CAA aimed at defining the exact point at which CAA support would be made available in the future. Such an agreement would allow for a rapid response to future major problems of this sort and clearly define who bears what risks in this regulated company. The need for such clarity, coupled with the need for rapid reactions on the regulatory front, has been one of the major lessons learned from this whole experience.

Although this process of restructuring is not yet complete, there is a reasonable chance that we will get the agreement of all parties by the end of August.

SUMMARY AND CONCLUSIONS

The resilience NATS has shown to the consequences of September 11th illustrates that it is too simplistic to regard the financial structure of PICs as the sole indicator of their robustness. We have also to understand the details of their broader conditions in order to reach sound conclusions. Factors such as the level of free cash available to service the financial charges, the amount of cost reduction expected, the new management's skill in controlling operating cash demands, the behaviour of the board, the commitment of the owners and their willingness to inject more capital, the ongoing support of the lenders, the availability of new investors, and the support of the regulator must all be taken into account.

Nevertheless, certain features of the PIC can be viewed as introducing inherent weaknesses. First, it seems unlikely that the full range of risks they face are generally appreciated. Second, broadly "Not for Profit" structures tend to limit the number of potential investors and the amount of capital they will expose, and they will also tend to concentrate risk through lack of diversification. The high debt structures which follow create inevitable tensions between owners and lenders in the event of problems and do not themselves provide the new companies with the risk protection provided by lower debt ratios.

In conclusion, a better balance of risk would probably be achieved by designing these new companies to give a regulated return on investors' capital. This would broaden their access to capital without allowing market pressures to distort their purpose, and also create the potential for risk diversification. It would then



become possible to reduce the debt on their balance sheets and thus provide more resilience to the hidden risks which almost certainly exist.