Appendix N: Financeability

In CAP 2160, the CAA highlighted the need for an appropriate balance between affordability and financeability. We believe our plan achieves this by making efficient use of NERL's balance sheet to suppress price increases during NR23, together with actions taken to control cash flow and costs in 2020-22 which have been retained as far as possible in our NR23 plan.

The refinancing in 2020 and 2021 provided a new foundation for our business plan and enabled us to offer greatly improved pricing during NR23 than would otherwise have been possible. We have gone beyond what is being offered by other European Air Navigation Service Providers (ANSPs) in a number of ways, including:

› a price reset from 2023 rather than 2022, deferring price rises to customers while the effects of the pandemic are still acute

› price profiling within NR23 to keep prices flat, meaning that prices are lower at the start of the period while traffic is recovering, than would otherwise be the case

› recovering of 75% of the 2020-22 revenue shortfalls (the traffic risk sharing (TRS) debtor) over NR23

› deferring recovery of 25% of the TRS debtor to NR28, spreading recovery over 10 years

Further suppressing prices in NR23, beyond what we offer in this business plan, would reduce the company's ability to withstand further significant traffic shocks. It may also lead to an outcome that is at odds with the gearing cap within our licence, and which is already at risk of being exceeded in certain downside scenarios, under this plan as positioned. That cap exists to protect customers by reducing the likelihood that NERL is unable to meet its licence and statutory obligations as a result of being in financial difficulties due to high levels of financial gearing.

In its guidance, the CAA encouraged NERL to consider price profiling, to set out target credit ratings, to use metrics for assessing both debt and equity financeability, to set out target leverage for the notional company and dividend assumptions, and to show that incentives are appropriately calibrated. These matters are described in more detail below. In our assessment, our plan is financeable on the basis that:

› the ***average*** gearing of 41% over NR23, assuming STATFOR October 2021 base case traffic from September 2021 onwards, is expected to provide appropriate headroom relative to the new bank facility financial covenant of 85%. On these assumptions, [✂ redacted]. Under less optimistic assumptions for traffic over 2022 and NR23 than in STATFOR's base case, namely no improvement in traffic in 2022 followed by a delay in recovery of traffic over NR23 relative to the forecasts assumed for setting prices, ***average*** gearing over NR23 is anticipated to be nearer to 60%, with peak gearing potentially [✂ redacted] (refer to the downside scenarios below). This highlights the significant traffic volatility risk that exists for NERL over NR23

› it includes the prospect of dividends in NR23 [✂ redacted], after no dividends to date in RP3

- the credit rating ratios in the base case and downside scenarios provide a reasonable prospect that NERL will remain at, or above, the target credit rating of the notional company during NR23. Evidence is provided below to support these conclusions

This assessment of financeability is based on assumptions for: traffic, cost of capital, regulatory mechanisms (eg treatment of the TRS debtor) and our operating efficiency in 2020-22 that are set out in our business plan.

Licence requirements

In line with the requirements of our licence, our business plan ensures we maintain an investment grade credit rating and it assumes a ceiling of 65% for our gearing (calculated as the ratio of net debt to the Regulatory Asset Base (RAB)).

Target credit rating

Consistent with the gearing cap in our licence, we consider the target credit rating for the notional company to be A3/A-, based on our interpretation of rating agency guidance and how the agencies assess our gearing levels. Our actual credit rating is expected to be higher than the target rating for the notional company, due to the uplift given by both Moody's and S&P for their assessment of the likelihood of extraordinary government support. This reflects a combination of the level of government shareholding in NATS Holdings Limited and the nature of the services provided by NERL and their importance to the UK economy. Customers benefit from NERL having a higher credit rating, currently A+/A2, as it leads to a lower cost of debt.

We maintain our view from RP3 that targeting a higher credit rating would not be in the interest of customers, as it is likely that higher profit margins and therefore prices would be required to support such a rating. Similarly, we continue to hold the view that a credit rating target that is lower than A3/A- would be inconsistent with the gearing cap in our licence. This is because, assuming all other credit considerations remained as they are, an increase in NERL's gearing to the cap of 65% would not necessarily lead to a credit rating downgrade. By implication, the range of acceptable gearing levels at lower credit ratings would include gearing that is higher than 65%. Given that NERL is not permitted to have gearing that high, it is therefore not logical for the company to target a credit rating that is lower than A3/A-.

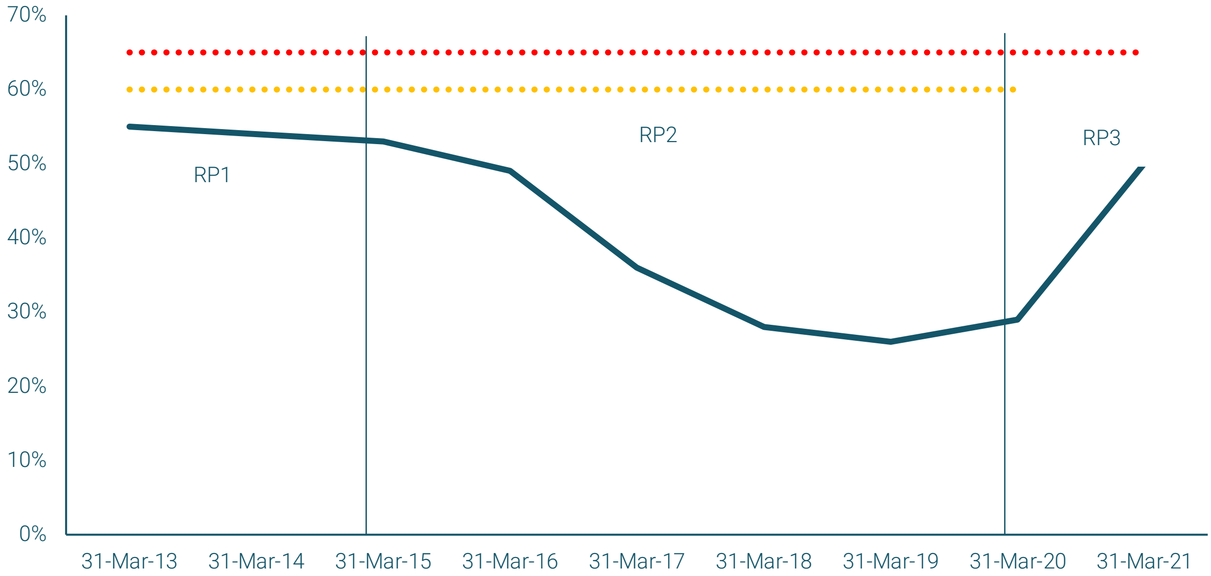
Based on this notional company target, we consider that a successful credit rating-based financeability test is one where the evidence indicates no clear expectation that our credit rating would be lower than A3/A-.

Target leverage

In its guidance to NERL, and with reference to its guidance to Heathrow Airport, the CAA identified two broad options for addressing how the gearing of a notional ANSP may have changed as a result of the pandemic.

The first of these is to assume that dividends would have reduced and its shareholders would have injected equity to preserve the notional gearing. For NERL, this could mean maintaining the RP3 notional gearing assumption of 30%. The second being to assume that the loss of revenues would have been addressed, at least in part, by issuing new debt. This would imply that a higher opening notional gearing should be assumed for NR23.

Rather than just reduce dividends in response to Covid-19, we paid no dividends in 2020 or 2021. This action, along with dividend restraint over the years leading up to the pandemic (most notably the RP2 period), has been critical to the company's ability to fund the shortfall in operating cash receipts. The chart below shows how our gearing reduced over RP2 from a more normalised level of around 50%-55% in RP1, and has started to climb during RP3 back towards this level.



NERL's gearing 2013 - 2021[1]

In the context of this low opening gearing of 29% in 2020 (close to the RP3 notional leverage of 30%), and the significant headroom relative to the gearing cap of 65%, we consider that a notional ANSP would, like NERL, have absorbed the impact of lower cash receipts from customers by issuing new debt and suspending dividend payments.

This assessment is supported by evidence presented in the cost of capital study[2] which shows that the gearing levels of comparable companies, chosen for the purposes of estimating our cost of capital, have increased since they were examined by the Competition and Markets Authority (CMA) as part of the RP3 determination. For example, the gearing of Aéroports de Paris and Fraport has increased by almost 20 percentage points, and Italian ANSP, ENAV's has increased by 39 percentage points when looked at, like NERL, on a net debt/RAB basis.

Together these support an assumption that the opening gearing for the notional ANSP should take into consideration the actual projected gearing for NERL at the start of NR23. Depending on actual levels of traffic over 2022, NERL's gearing which was 50% at 31 March 2021 (vs 29% at 31 March 2020) is thought likely to be in the range of [✂ redacted] by the start of NR23. We consider, however, that the gearing of the notional ANSP would trend down slightly over NR23. Taking this into account we consider that an appropriate target leverage over NR23 for the notional ANSP would be in the region of 50%.

Our approach to target leverage also takes into consideration projected gearing under a range of credible downside traffic scenarios. In these scenarios, which also reflect cost risks faced by NERL over NR23, we consider that average gearing of over 60% or gearing above 65% for more than a year would have longer term adverse impacts on NERL's cost of capital and would also not be acceptable to the CAA, in the context of our licence requirements.

Business plan modelling assumptions for dividends

[✂ redacted]

[1] For RP3, the gearing target in NERL's licence was changed by CAA to being a monitoring threshold level.
[2] Cost of capital for NR23, dated 28 October 2021, section 5.3 Market evidence p51-52

Decisions around future dividends during RP3 and NR23 will be taken by our Board at the relevant time.

[✂ redacted]

NERL dividends 2015 – 2027

Calibration of incentives

The incentives within our NR23 business plan relating to delay metrics and flight efficiency are calibrated in an asymmetrical fashion, meaning that there is a skew towards the prospect of performance penalties. Likewise, in relation to the capex governance incentives, the calibration is not symmetrical and we only face downside risk. Notwithstanding this asymmetric risk, our base case and downside scenarios do not contemplate any service quality or capex incentive penalties. We consider this to be the most appropriate approach to take, and it is also in the interests of our customers not to presume that penalties would apply. However, to the extent that the CAA alters the requirements, targets or penalties in a meaningful way, we will need to re-address this assumption as part of our ongoing financeability analysis.

Stress testing our business plan

We consider adverse traffic outcomes to be the most significant risk to NERL's financeability, followed by operating cost overruns, for example in scenarios in which we are unable to fully sustain the savings built in following Covid-19, if dual running/sustainment costs are higher than assumed, or if single till income risks materialise. To demonstrate the financeability of our business plan, we set out the following three downside scenarios:

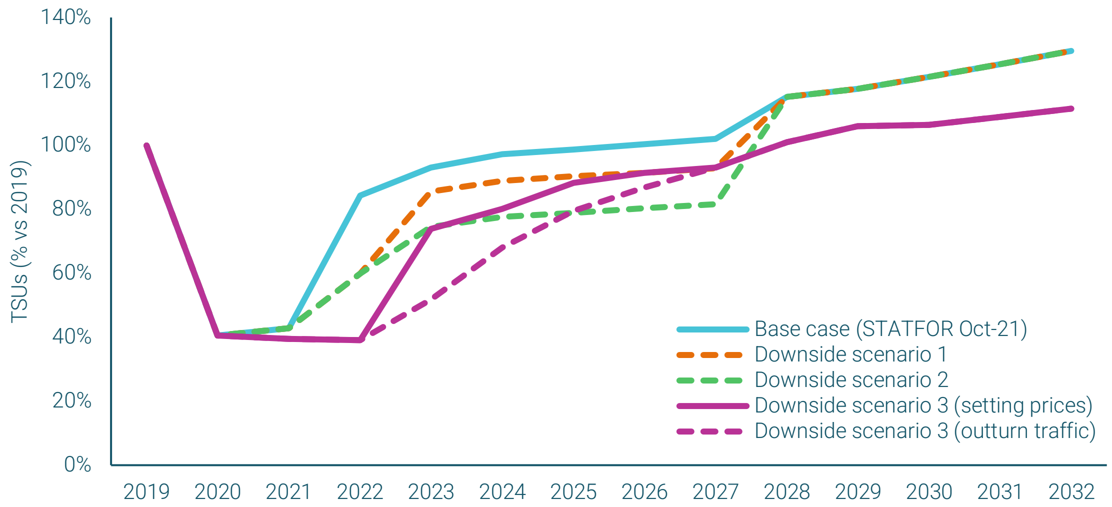
- Downside scenario 1: In this scenario, prices over NR23 are set with reference to the STATFOR October 2021 base case (blue line in the chart below), but outturn traffic and Traffic Service Units (TSUs) are lower than this. Actual traffic in 2022 is assumed to be 60% of 2019 levels (versus 84% in the base case), followed by a recovery in traffic and TSUs that broadly trend towards the STATFOR October 21 low case by the end of NR23 (dotted orange line in chart below). In addition, it is assumed that annual operating costs exceed the NR23 settlement by £9m pa (in 2020 prices) due to higher dual running and sustainment costs should the transition to new technology take longer or be more complex than currently projected, or should it not be possible to fully sustain savings built into our plan following Covid-19. In the context of the significant traffic volatility at present, this is considered to be a medium/high likelihood scenario

- Downside scenario 2: In this scenario, we also assume that prices over NR23 are set with reference to the STATFOR October 2021 base case, but outturn traffic and TSUs are lower than this. In this scenario, actual traffic in 2022 is assumed to be 60% of 2019 levels (as per downside scenario 1), but then the recovery in traffic is weaker than in downside scenario 1. Specifically, we assume that TSUs are 20% lower than the STATFOR October 2021 base case throughout NR23 (dotted green line in chart below). The annual operating costs overruns assumed in downside scenario 1 are also applied to downside scenario 2. This is considered to be a medium likelihood scenario

- Downside scenario 3: In this scenario, we assume that TSUs in Q4 2021 fall slightly behind the STATFOR October 21 base case and then stay flat at 2021 levels throughout 2022. We then assume that prices are set for NR23 by the CAA using a new forecast (solid pink line in chart below). This new forecast assumes that TSUs in 2023 are at 74% of 2019 levels. This new forecast then assumes a gradual return to the STATFOR October 2021 low case by the start of 2026. Outturn traffic in this scenario assumes that TSUs are at 52% of 2019 levels throughout 2023, and then recover to the STATFOR October 2021 low case by 2027 (dotted pink line in chart below). In this scenario, no opex overruns are assumed as we consider that it will be more likely that we could fully sustain the Covid-19 savings at these lower levels of traffic. As forecast actual TSUs in 2023 in this scenario are 30% lower than assumed for prices setting in that year (TSUs of 6,519k versus

9,313k), our proposed adjusted traffic volume risk sharing mechanism would apply (see Appendix P). While this scenario is necessarily somewhat speculative, it is in our view a highly credible downside scenario given the spread of the omicron variant and the downside risks to traffic recovery more broadly. We attach a low/medium likelihood to this scenario

The TSU assumptions associated with these downside scenarios are set out in the chart below. In these scenarios, it is still assumed that prices in NR23 prior to NR23 traffic volume risk sharing adjustments are flat (in 2020 prices).



Downside scenario TSU assumptions

The results of our testing are shown below. Noting that the key metrics are at their tightest at the start of NR23, and as such NERL is most exposed to further shocks around that time, we will continue our downside scenario testing over the course of 2022, so that we are well-placed to response expediently to the CAA's initial proposals for NR23 when they are published in June 2022[3].

Base case financeability metrics

Our key financeability metrics and targets are set out in the table below:

Metric	Description	Target	Relevance
Gearing (%)	Net debt / RAB ratio	50% average in base case 60% average in downside scenarios 65% ceiling	Ability to withstand further traffic shocks Licence requirement
Liquidity (£m)	Cash and committed undrawn bank facilities (assuming existing revolving credit facility is remained throughout NR23)	Minimum of £400m in base case Minimum of £50m in downside scenarios	Estimated level of liquidity required to accommodate further traffic shocks & NATS liquidity policies
Adjusted net debt / RAB (%)	Gearing ratio, as defined by Moody's	No higher than 70%	At this level NERL's credit rating is at risk of being downgraded by Moody's

[3] CAP 2160 – Key dates page 12

FFO / net debt (%)	Adjusted funds from operations / net debt As defined by Standard & Poor's ("S&P")	18% (measured as an average over a rolling 2 years)	Ratios lower than this could trigger a rating downgrade by S&P
Ex-post regulatory return (%)	Forecast regulatory return	Base case outcome – closely aligned with estimated cost of capital Downside scenarios – above the real cost of debt	Whilst shareholders recognise and accept the risk that the actual return can be lower than the real cost of debt, this floor of -1% is considered to be appropriate in the context of these credible scenarios.

Financeability metrics and targets

Financeability metrics under downside scenarios

The outcomes of our downside tests on the financeability metrics and targets are shown in the table and charts below.

[✂ redacted]

Financeability outcomes under downside scenarios

[✂ redacted]

NERL gearing projections under downside scenarios

[✂ redacted]

NERL liquidity projections under downside scenarios

The financeability targets are all met under the base case. These outcomes are however predicated upon traffic in 2022, across the full year, being more than 80% of 2019 levels. Given the growth in the omicron variant, this is looking increasingly unlikely.

In downside scenario 1, [✂ redacted].

In downside scenario 2, [✂ redacted].

Given the spread of the Omicron variant and the continued risk of further variants, downside scenario 3 is an increasingly relevant scenario. In this scenario, [✂ redacted].

Overall, therefore, we consider that our business plan is financeable under a range of stress test scenarios and appropriate underlying assumptions. As referenced above, it is however predicated upon a number of important judgements; most critically in relation to the TRS debtor and the cost of capital, areas that the CAA has not yet formed its own views. Should the CAA form materially different views on these points from those which underpin our plan, or indeed in relation to other aspects of our plan, the financeability of our plan would need to be reconsidered.