

Gatwick Airport

Response to the Department for
Transport Consultation on Promoting
Financial Resilience for Major Airports

February 2010



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Foreword

Since its takeover by Global Infrastructure Partners (GIP) in December 2009 Gatwick Airport has been fully independent of BAA.

The financial stability of our business and financial resilience is very important to us. Nevertheless, financial ring-fencing conditions can have adverse implications for the cost of raising debt finance and so have both advantages and disadvantages. Consistent with good business practice Gatwick Airport needs to have continuing access to financing on cost-effective terms if it is to actively compete with other airports, fund the investment necessary to improve services to passengers and enhance capacity.

In the light of these considerations we welcome the DfT's consultation on Promoting Financial Resilience for Major Airports and look forward to further discussions on the drafting of financial ring-fencing conditions and the arrangements for derogations from these conditions.

Key Issues

1. The divestment of Gatwick Airport by BAA has significantly increased the scope for competition between airports in the South East of England. In order to be successful in a competitive market it will be necessary for Gatwick Airport to have access to low-cost finance to fund investment in both service quality and capacity enhancements. Given the importance of this investment to the passenger experience – which is the focus of government and regulatory policy on airports – there are strong arguments for allowing Tier 1 airports to continue to access efficient and cost effective financing.
2. A secured debt structure, similar to that used by BAA (the closest benchmark for debt markets and the only other owner of Tier 1 airports) and Tier 2 airports, would have significant advantages in terms of achieving higher credit ratings and an optimum debt package at competitive pricing. This is consistent with evidence from Standard & Poor's, as cited by the DfT in its consultation paper, indicating that uncertainty associated with security arrangements could lead to a multi-notch downgrade in the credit rating of debt. A financing structure involving secured debt would require a derogation from the financial ring-fencing condition prohibiting a licensee from granting security over the assets of a regulated business. It would also be advantageous to have the flexibility to explore other financing arrangements that would require derogations from the financial ring-fencing conditions, such as restrictions on asset disposals amongst others.
3. We welcome the clarity that has been brought to this position with respect to the initial derogations and note that the DfT has committed to the derogations for financing structures existing at the time licences are issued. In particular that *“there will be derogations for the elements to which this analysis applies. These elements are those that cut across financing arrangements in place at the time the relevant licence condition is being*



*finalised*¹. In relation to our current financing there is a certain degree of flexibility around regulatory changes (including the ring-fencing conditions) but this flexibility is only for a short grace period to allow for discussions with lenders on possible ways forward. If a solution could not be reached this would lead to an Event of Default and so derogations from the financial ring fencing conditions are likely to be required. Any re-financing that takes place in the period until licences are finalised is also likely to require derogations from the financial ring-fencing conditions.

4. While we welcome the commitments made by the DfT with respect to existing financing (i.e. that in place when the licences are finalised) there is considerable uncertainty with respect to the timetable for finalising the licences. In its December 2009 Decision Document the DfT noted that *'once royal assent has been given to the legislation significant further work will be required to develop the final form of the licences'*². An airport could be in the middle of a re-financing exercise when licences are introduced, and in these circumstances the introduction of financial ring-fencing could be very disruptive, not only to the financing arrangements but also the associated investment projects. On this basis there is a strong case for extending the initial derogations from existing financing to the financial arrangements that can be reasonably envisaged at the time the licences are finalised.
5. In relation to future financing (i.e. that not in place when the licences are issued) the introduction of licences should not restrict access to low cost financing as this would risk distorting competition and reducing investment. Where competition is concerned issues arise not only in relation to Tier 1 airports, where the incumbent operator (BAA) may have advantages arising from having long established financing arrangements, but also in relation to Tier 2 airports that have the potential to grow rapidly and will not be subject to financial ring-fencing. In the light of these considerations, further derogations should be given to Tier 1 airports where they promote access to low cost finance and the underlying principle – that financial ring-fencing should not obstruct access to low cost financing – should be embedded in the licence.
6. In relation to the specific questions raised by the DfT in its December 2009 consultation Gatwick Airport has the following comments.

Should the regulatory regime include a licence condition in Tier 1 licences to produce and maintain a Continuity of Service Plan (CSP) in the initial licence and allow the regulator to introduce such a licence condition in future licences?

7. It is not clear that there are any significant benefits associated with a CSP licence condition and so the Tier 1 licences should not include this condition.

If such a licence condition were to be introduced, what would be the costs and benefits of such a step?

8. There are a number of considerations that suggest there would be no significant benefits from CSP licence condition:
 - insolvency practitioners are experienced in keeping complex businesses running without reference to a CSP and there is no evidence that the operation of an airport

¹ DfT Consultation Document on Promoting Financial Resilience for Major Airports, December 2009, paragraph 24

² DfT Decision Document on Reforming the Framework for the Economic Regulation of Airports, December 2009, paragraph 4.65



would present any insurmountable challenges to an experienced insolvency practitioner, and

- a CSP has not been introduced for other regulated utilities (such as gas and electricity) – despite the fact the costs of disruption in these services would be much higher than for a Tier 1 airport. On this basis the specialist sectoral regulators (which have considerable expertise in financial resilience conditions) do not appear to regard a CSP as important to the protection of consumers in the circumstances of administration.

If such a licence condition were to be introduced, is there any information in the list above that is not required, and why is it not required? Is there any additional information that should be included in a CSP, and if so why?

9. It is not clear that any of the information contained in the CSP is required. However, if the DfT is going to insist on this approach it should consider focusing the condition on key employees and their responsibilities. This would allow an insolvency practitioner ready access to the individuals that have the specialist knowledge to keep the airport running. In contrast, documentation relating to capital expenditure, suppliers, financing and so on would be of little or no use in the day-to-day running of a relatively complex business.

If such a licence condition were to be introduced, how often or on what basis would the plan need to be updated in order for it to remain relevant?

10. There would be no point in having this information available or updating it when the business was operating on a normal basis and on a sound financial footing. Therefore, if some or all of this information is to be required then this should be associated with an appropriate trigger event – such as the loss of an investment grade credit rating.

Do you agree that for the removal of initial derogations there should be a supplementary test for the regulator to consider?

11. The removal of the initial derogations from financial ring-fencing could have very material consequences for the licensee and restrict its ability to access competitively priced financing. Therefore debt markets will need reassurance that the initial derogations would only be removed when they are no longer necessary. It is not clear that providing a supplementary test for the regulator is going to be adequate in these respects. A more robust approach would involve additional reassurance, with a supplementary test and setting the initial (and any further) derogations for a minimum period consistent with the term of the financing arrangements in place, perhaps in conjunction with a requirement that the licensee maintains a certain level of creditworthiness. These arrangements would have a number of significant advantages, including providing certainty for credit markets and protecting capital market competition by reducing the uncertainty associated with takeovers and acquisitions.

Do you agree that the proposed supplementary test consisting of a material change in circumstances and cost benefit analysis would achieve the DfT's objective outlined in paragraph 9?

12. The DfT's objectives focus on developing additional certainty as to the circumstances in which the regulator is allowed to remove the derogations while, at the same time, allowing the introduction of full financial ring-fencing when appropriate. As explained above in paragraph 11 there is a strong argument for setting the initial derogations for a minimum period consistent with the term of the financing arrangements that would trigger the derogation. We agree with the DfT that any supplementary test should focus on the costs



and benefits of removing the derogation and that there should be consistency with the approach for granting the initial derogations, where the DfT has committed to issuing derogations where there would be significant costs associated with the introduction of financial ring-fencing.

13. The position is particularly acute in respect of derogations necessary to allow secured debt structures. Market evidence indicates that these arrangements have the potential to offer cost effective debt financing for airport investment. In this respect the position is markedly different to the energy and water sectors which already have financial ring fencing arrangements in place. There are also differences in the underlying economic characteristics of the assets in these sectors compared to airports. In water and energy distribution there is no alternative to the use of the network assets and the network represents a true natural monopoly, with the loss of any part of the network having catastrophic implications to the consumers receiving network services. In airports there is a degree of substitution between assets and increasing competition between both Tier 1 and Tier 2 airports. In the light of all these factors there would be advantages in the DfT and CAA making a joint statement when the licences are introduced, recognising the importance of secured debt financing and committing to review the associated derogations only if all of the following conditions were to be satisfied:
- any minimum period has elapsed
 - the business has fallen below a minimum level of creditworthiness, and
 - the cost advantages associated with this form of financing no longer apply.

If you disagree what alternative would you suggest that meets the DfT's objective, and why?

14. See paragraphs 11 to 13 above.

Do you agree that the appeals of a decision by the regulator as to whether the conditions for removal of the initial derogations have been satisfied should be to the Competition Commission on an adjudicative basis and that the parties who should be able to appeal are the regulated company, Passenger Focus and the Secretary of State?

15. Gatwick Airport is content with the proposal that appeals on derogations should be made to the Competition Commission on an adjudicative basis and that the parties able to appeal would be the regulated company, Passenger Focus and the Secretary of State.

Summary

We would like to emphasise the following.

- There would be few if any benefits from the introduction of a CSP licence condition. If it is to be introduced it should focus on providing information on key employees and be triggered by a material event – such as the loss of an investment grade credit rating.
- The initial and any further derogations from the financial ring-fencing conditions should stay in place for a minimum period consistent with the term of the financing arrangements in place when the licence is issued. The derogation relating to secured debt structures should only be reviewed if the cost advantages associated with this form of financing were no longer to apply.



- It is important that the regulator considers the costs to the licensee of removing any derogations, the impact on competition and the adverse consequences for investment and passengers. This principle should be reflected in the licence.
- We support the DfT's proposal that appeals on derogations should be made to the Competition Commission.
- Gatwick Airport welcomes the clarity that has been brought to the position on the initial derogations and notes that the DfT has committed to the derogations for financing structures existing at the time licences are issued.
- There is a strong case for extending the initial derogations from existing financing to the financial arrangements that can be reasonably envisaged at the time the licences are finalised.
- The introduction of licences should not restrict access to low cost financing as this would risk distorting competition and reducing investment. This principle should be embedded in the licence.

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